Hastings Law Journal

Volume 27 | Issue 2 Article 5

1-1975

Separate Statutory Treatment of the Close Corporation in California: Progress and Problems

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SEPARATE STATUTORY TREATMENT OF THE CLOSE CORPORATION IN CALIFORNIA: PROGRESS AND PROBLEMS

A bill recently passed by the California Legislature will effect a thorough revision of California's General Corporation Law.[1] A significant portion of that bill devotes itself to the problems of the close corporation,[2] long considered the stepchild of American corporation law. Over the last thirty to forty years, numerous writers have deplored the plight under existing corporation laws of small businesses, organized essentially for the employment of their shareholders.[3] The structure forced upon those desiring limited liability is, they say, uselessly demanding and archaic.[4]

California, in its revision of the Corporation Law, gives recognition to this insistent argument for change by allowing increased flexibility to the participants in a statutorily defined close corporation. The revision, however, goes no further than the advances made by some of California's sister states,[5] and in many respects falls short of the comprehensive statutory treatment of the close corporation presented by the most innovative states.[6] Nevertheless, by enacting the bill into law,

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1. A.B. 376 (1975).

2. *Id.* §§ 158, 186, 202(a), 204(a), 300, 418, 421, 705(e)(5), 706(a), 1111, 1201(e), 1800.

3. *See, e.g.*, F. O'NEAL, CLOSE CORPORATIONS: LAW AND PRACTICE (2d ed. 1962) [hereinafter cited as O'NEAL]; Bradley, *Toward a More Perfect Close Corporation: The Need for More and Improved Legislation*, 54 GEO. L.J. 1145 (1966) [hereinafter cited as Bradley, *Toward a More Perfect Close Corporation*]; Hetherington, *Special Characteristics Problems and Needs of the Close Corporation*, 1969 U. ILL. L.R. 1; Kessler, *The Statutory Requirement of a Board of Directors: A Corporate Anachronism*, 27 U. CHI. L. REV. 696 (1960); Oppenheim, *The Close Corporation in California: Necessity of Separate Statutory Treatment*, 12 HASTINGS L.J. 227 (1961) [hereinafter cited as Oppenheim]; Winer, *Proposing a New York "Close Corporation Law"*, 28 CORNELL L. REV. 313 (1943); Note, *A Plea for Separate Statutory Treatment of the Close Corporation*, 33 N.Y.U.L. REV. 700 (1958).

4. *See, e.g.*, 1 O'NEAL, *supra* note 3, at §§ 1.12, 1.13, 1.13a; Bradley, *Toward a More Perfect Close Corporation*, *supra* note 3, at 1145; Oppenheim, *supra* note 3, at 228.

5. *See, e.g.*, ME. REV. STAT. ANN., tit. 13-A, §§ 102(5), 407(5), 607(1), 701 (Supp. 1973); N.C. GEN. STAT. §§ 55-24, -73, -125(a) (1975); S.C. CODE ANN. §§ 12-16.15, -16.22, -22.15 (Supp. 1974).

6. *See, e.g.*, DEL. CODE ANN., tit. 8, §§ 351-58 (1974); MD. ANN. CODE, art. 23, §§ 100-11 (1957); TEX. BUS. CORP. ACT ANN., arts. 2.30-1 to -5 (Supp. 1974).

California has made a significant stride in the direction of increased statutory recognition of the needs of small businesses.

The bill is the product of extensive research and discussion by the Committee on Corporations of the State Bar of California and the California Assembly Select Committee on the Revision of the Corporations Code.[7] The two groups produced several drafts of the bill which were circulated for comment and criticism to local bar representatives, professors of corporation law, and corporation attorneys.[8] The final draft of the bill was then written, and on January 2, 1975, it was submitted to the Assembly. After several amendments, the bill passed both houses of the legislature, and was signed by the governor on September 12, 1975.[9] The new law will not become effective until January 1, 1977, and in the interim, a committee will be appointed to review, criticize and propose amendments to improve the measure.[10]

This comment will attempt to analyze the probable effect of the new law on small business electing to become close corporations under the terms of the measure. This analysis will include an attempt to define the nature of a close corporation, a brief review of its historical treatment under general corporation law, a discussion of the mechanics of the California bill as they relate to close corporations, and finally a consideration of the effectiveness of those mechanics in light of the most common problems encountered by the close corporation: arranging the management of its affairs, restricting the transfer of its stock, agreeing on shareholder votes, and meeting attempts under the alter ego doctrine to hold the shareholders personally liable for the debts of the corporation.

What is a Close Corporation?

A close corporation is typically a small business. For example, it commonly arises when the partners actively engaged in the business of a partnership incorporate that partnership.[11] A close corporation is often a family concern in which relatives hold shares and actively participate in the running of the business.[12] In addition, a sole proprie-

7. 1 STATE BAR OF CALIFORNIA, COMMITTEE ON CORPORATIONS, EXPOSURE DRAFT: GENERAL CORPORATION LAW (1974).

8. *Id.* at 1-4.

9. ASSEMBLY DAILY HISTORY, 1975-76 Reg. Sess., Sept. 19, 1975. The bill was amended on April 1, 1975, May 1, 1975, May 21, 1975, August 5, 1975, August 19, 1975, and September 2, 1975. *Id.*

10. Los Angeles Daily Journal, Sept. 16, 1975, at 1, col. 3.

11. *See, e.g.*, Galler v. Galler, 32 Ill. 2d 16, 203 N.E.2d 577 (1964); Seitz v. Michels, 148 Minn. 80, 181 N.W. 102 (1921).

12. *See, e.g.*, Galler v. Galler, 32 Ill. 2d 16, 203 N.E.2d 577 (1964).

tor's incorporation of his business usually makes that business a close corporation.[13]

While it is easy to give examples of what can constitute a close corporation, it is more difficult to attempt to isolate the characteristics peculiar to a close corporation. Numerous attempts have been made, not all of them successful.[14] Nevertheless, it can be said with safety that a close corporation usually exhibits most of the following traits:

1) It is a corporation.
2) It has few shareholders, often fewer than ten.
3) Its shareholders know each other.
4) Its shareholders are active in the management of the business.
5) Its shareholders constitute the board of directors.
6) Its shares are not freely transferable.
7) Its shares do not have a general market.[15]

The mere enumeration of these traits suggests many of the problems of close corporations under general corporation law. The general corporation statutes contemplate a hierarchy within the corporation consisting of shareholders, directors, and management.[16] In the close corporation the participants commonly take on two or three of these roles and give little regard to the significance each holds. The general corporation statutes provide for free transferability of shares on the assumption that this flexibility will encourage the investment of risk capital in businesses. The close corporation, however, looks to those active in its operation for equity investment and uses shares to represent each individual's stake in the business. Free transferability of the shares in a close corporation would prove more a disruptive threat to business than an aid in the attraction of risk capital.[17]

While the general corporation statutes presume an autonomous board of directors solely responsible for running the business of the cor-

13. *See, e.g.*, McCombs v. Rudman, 197 Cal. App. 2d 46, 17 Cal. Rptr. 351 (1961).

14. *See, e.g.*, 1 O'NEAL, *supra* note 3, § 1.07; Oppenheim, *supra* note 3, at 228; Tennery, *Potential of the Close Corporation: A Question of Economic Validity*, 14 How. L.J. 241 (1968); Wolens, *A Round Peg—A Square Hole: The Close Corporation and the Law*, 22 Sw. L.J. 811 (1968). The New York Law Revision Commission gave up its attempt and concluded that there was no adequate way to define a close corporation. 1948 N.Y. LAW REV. COMM'N REP. 386.

15. *See* 1 O'NEAL, *supra* note 3, § 1.07; Oppenheim, *supra* note 3, at 227.

16. N. LATTIN, THE LAW OF CORPORATIONS (2d ed. 1971) § 69 [hereinafter cited as LATTIN].

17. *See* Tu-Vu Drive-In Corp. v. Ashkins, 61 Cal. 2d 283, 391 P.2d 828, 38 Cal. Rptr. 348 (1964). See also notes 142-147 & accompanying text *infra*.

poration, the function of the board in a close corporation is generally made irrelevant by the identity of shareholders, directors, and officers, and the close corporation participants' desire for longevity of employment can lead to agreements that sterilize the function of the board of directors.[18] The general corporation statutes contemplate a corporate democracy in which the vote of the majority of shares prevails. This approach is felt to lead to efficiency and fairness in deciding the long range policies of the corporation. In the close corporation, however, disputes among the participants may reverberate throughout the organization,[19] and the majority vote can lock into the corporation shareholders who disagree with the policies of the majority.[20]

History of the Treatment of Close Corporations

Given the disparity between the needs and desires of the participants in a close corporation and the function served by the corporate model traditionally presented in corporation statutes, it is not surprising that close corporation participants have made efforts to circumvent the strictures of the corporation laws and that the courts as interpreters of the same laws have often thwarted these schemes. Historically, such efforts have included voting trust agreements,[21] irrevocable proxies,[22] vote pooling agreements by both shareholders and directors,[23] long-term employment contracts,[24] agreements restricting action by the board of directors,[25] certain share transfer restrictions,[26] and high quorum and high vote requirements for shareholders' and directors' meetings.[27] The courts in this country at one time or another have invalidated them all, giving such reasons as the preservation of corporate democracy,[28] inability under the law to separate voting rights in

18. See notes 86-103 & accompanying text *infra*.

19. *See, e.g.*, Jackson v. Hooper, 76 N.J. Eq. 592, 75 A. 568 (1910); McQuade v. Stoneham, 263 N.Y. 323, 189 N.E. 234 (1934).

20. *See* 2 O'NEAL, *supra* note 3, § 9.02.

21. *See, e.g.*, Abercrombie v. Davies, 35 Del. Ch. 599, 123 A.2d 893 (Ch. 1956), *modified*, 36 Del. Ch. 102, 125 A.2d 588 (Ch. 1956), *rev'd on other grounds*, 36 Del. Ch. 371, 130 A.2d 338 (Sup. Ct. 1957).

22. *See, e.g.*, Thomsen v. Yankee Mariner Corp., 106 Cal. App. 2d 454, 455, 235 P.2d 234 (1951).

23. *See, e.g.*, Morel v. Hoge, 130 Ga. 625, 61 S.E. 487 (1908); Odman v. Oleson, 319 Mass. 24, 64 N.E.2d 439 (1946).

24. *See, e.g.*, Odman v. Oleson, 319 Mass. 24, 64 N.E.2d 439 (1946); McQuade v. Stoneham, 263 N.Y. 323, 189 N.E. 234 (1934).

25. *See, e.g.*, Jackson v. Hooper, 76 N.J. Eq. 592, 75 A. 568 (1910).

26. *See, e.g.*, Rafe v. Hindin, 23 N.Y.2d 759, 296 N.Y.S.2d 955, 244 N.E.2d 469 (1968).

27. *See, e.g.*, Benintendi v. Kenton Hotel, 294 N.Y. 112, 60 N.E.2d 829 (1945).

28. *Id.* at 118-19, 60 N.E.2d at 831.

stock from stock ownership,[29] and the preservation of the board of directors as the management body of the corporation.[30]

The hostility shown in these opinions toward close corporation agreements is surprising when it is considered that the participants in the close corporations were commonly the only ones who would have gained or lost by these arrangements. *State ex rel. Ross v. Anderson*[31] illustrates well the common judicial attitude. In that case, the shareholders of a small corporation agreed that the board members should sit until they died, resigned, or became incapacitated. The decision invalidated this arrangement because it conflicted with the statutory requirement that the board be elected each year.[32] The court rationalized its decision on the ground that the state made certain privileges available to corporations in return for the observance by these corporations of the statutorily prescribed formalities, and it concluded that to allow the parties in this case to alter the prescribed form by agreement "would seem to accord to the organizers of the corporation greater power than the sovereign, by whose will alone it exists and enjoys its privileges and immunities."[33]

One writer has characterized the attitude taken in decisions such as the preceding one as exhibiting an animistic belief that the corporate personality could be created and preserved only by the observance of certain statutorily prescribed rituals.[34] Nevertheless, behind the articulated rationales in these cases, there appear to have been legitimate concerns motivating the courts. If substantial variance from the corporate norm were allowed, large publicly held corporations could be manipulated in form so as to deprive minority shareholders of any say in the management of the business, and to defraud unsuspecting investors.[35]

Of course, this concern for the protection of unwitting parties seems less compelling in the context of a close corporation whose shareholders have all assented to the arrangement under which they will participate. The California Supreme Court early recognized this

29. Morel v. Hoge, 130 Ga. 625, 61 S.E. 487 (1908).
30. Jackson v. Hooper, 76 N.J. Eq. 592, 75 A. 568 (1910).
31. 31 Ind. App. 34, 67 N.E. 207 (1903).
32. *Id.* at 44, 67 N.E. at 210.
33. *Id.* at 42, 67 N.E. at 209.
34. Kessler, *With Limited Liability for All: Why Not a Partnership Corporation?*, 36 FORDHAM L. REV. 235 (1967) [hereinafter cited as Kessler, *Partnership Corporation*].
35. *See* 1. H. BALLANTINE & G. STERLING, CALIFORNIA CORPORATION LAW § 38 (4th ed. 1962) [hereinafter cited as BALLANTINE & STERLING]; Dodd, *Amendment of Corporate Articles Under the New Ohio General Corporation Act*, 4 U. CIN. L. REV. 129 (1930).

distinction when, in *Vanucci v. Pedrini*,[36] the court upheld as a valid agreement among a corporation's shareholders a bylaw prohibiting sale of their stock to outsiders unless a prior offer had been made to the corporation and its shareholders. In sanctioning the agreement the court quoted with approval a New Jersey decision which stated:

> In this court where the intent of the parties is the thing sought to be enforced, every effort should be made to hold men to agreements into which they have voluntarily entered, where the same are not obnoxious to any law or policy . . . . It is their business and their money which is involved. It is by their efforts that success is attained if attained at all.[37]

Recent years have revealed a greater willingness by courts to recognize the peculiar needs of close corporations and to distinguish between close corporations and other corporations in applying general corporate law.[38] Coupled with statutory changes in many states,[39] this new judicial attitude has created a friendlier atmosphere for close corporations. Nevertheless, in states with the traditional statutory framework that fails to distinguish between close corporations and other corporations, courts friendly to close corporations have been forced to carve out exceptions and twist statutory language in order to find room for close corporation arrangements.[40] These manipulations in turn have left questionable ambiguities in the law in a place where certainty is the most desired quality.[41]

The problem of the close corporation, then, has become in large part the problem with which this discussion began: how to define the close corporation and distinguish it from other business corporations.

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36. 217 Cal. 138, 17 P.2d 706 (1932).

37. *Id.* at 144-45, 17 P.2d at 708 *quoting* Baumohl v. Goldstein, 95 N.J. Eq. 597, 602, 124 A. 118, 120 (1924).

38. *See, e.g.*, Glazer v. Glazer, 374 F.2d 390 (5th Cir. 1967); Galler v. Galler, 32 Ill. 2d 16, 203 N.E.2d 577 (1964).

39. Space does not permit citation of all statutes relevant to close corporations. For examples of some of the better recent legislation, see statutes cited notes 5 & 6 *supra.*

40. *See, e.g.*, Peck v. Horst, 175 Kan. 479, 264 P.2d 888 (1953) (agreement violating statutes regulating the internal affairs of the corporation upheld on ground of waiver of statutory protection by shareholders party to the agreement); Clark v. Dodge, 269 N.Y. 410, 199 N.E. 641 (1936) ("slight deviations" from corporate norms permitted). *See also* Galler v. Galler, 32 Ill. 2d 16, 203 N.E.2d 577 (1964) in which the court discussed a number of Illinois decisions which upheld shareholder agreements on practical grounds—no apparent public injury, the absence of a complaining minority interest, and no prejudice to existing shareholders—even though the agreements technically violated the Illinois Business Corporation Act.

41. An Illinois court was forced to admit that the effect of upholding shareholder agreements which technically violated the corporations statutes "has been to inject much doubt and uncertainty into the thinking of the bench and corporate bar of Illinois concerning shareholder agreements." Galler v. Galler, 32 Ill. 2d 16, 28, 203 N.E.2d 577, 584 (1964).

If its problems are different, then its statutory treatment should be different, and if its statutory treatment is to be different, the close corporation must be defined.[42] Until corporation statutes differentiate between close corporations and other corporations, the courts will continue to be forced to construct a body of exceptions for the close corporation, and the participants in close corporations will be forced to tread cautiously lest they overstep this unclear line of judicial permissiveness.

The California Bill

Definition of a Close Corporation

The California bill is relatively straightforward in its treatment of close corporations. Section 158, in essence, defines a close corporation as one whose shares are held by no more than ten shareholders.[43] This numerical definition is patterned in part upon the Delaware Close Corporation Act.[44] Delaware adds, however, that the stock of the corporation must also be subject to restrictions on transfer, and that no public offering as defined under the 1933 Federal Securities Act can be made of the stock.[45] California does not include these additional requirements. While a mere numerical limit on the number of shareholders does not begin to describe the essence of a close corporation, it does reflect the recognition that a close corporation will not have many shareholders, and it does ensure some protection to the participants by making it more likely that they will have a large enough stake in the corporation to protect themselves in any bargaining.[46]

42. One commentator emphasizes the importance of a definition of a close corporation which is keyed to the bargaining power of the participants, since the consequence of close corporation status, at least under the Delaware act, is the replacement of the protection afforded the shareholders by board and shareholder votes with the bargained agreement of the parties. Comment, *Delaware's Close Corporation Statute*, 63 NW. U.L. REV. 230, 236 (1968) [hereinafter cited as *Delaware's Close Corporation Statute*].

43. A.B. 376 § 158 (1975). This definition results from the requirements in section 158 that the articles of a close corporation must place a limit on the number of its shareholders, not to exceed ten, and that an effective transfer of the stock that causes the corporation to have more shareholders than allowed by the articles will also cause the corporation to forfeit close corporation status. *Id.* For a discussion of when a transfer causing there to be more shareholders than the limit in the articles will be effective and when it will not, see notes 68-75 & accompanying text *infra*.

44. The Delaware statute specifies that to qualify under Delaware's close corporation act, the corporation's stock cannot be held by more than 30 shareholders. DEL. CODE ANN. tit. 8 § 342(a)(1) (1974).

45. *Id.* § 342(a)(2)-(3). One writer indicates that the combination of a limit on the number of shareholders in a close corporation and restrictions on the transfer of stock is a desirable approach because it makes the corporation the equivalent of partnership as far as the substitution of new members is concerned. Kessler, *Partnership Corporation, supra* note 34, at 255-56.

46. *See Delaware's Close Corporation Statute, supra* note 42, at 245.

The bill allows for the aggregation of stock holdings for purposes of satisfying the test that the corporation have no more than ten shareholders. Thus, husband and wife both holding shares in the corporation are treated as one shareholder regardless of how they hold their stock.[47] A trust, partnership, corporation or business association is also treated as one shareholder regardless of how many beneficiaries, trustees, partners, shareholders or members it may have.[48] Such an entity is not treated as one shareholder, however, if its primary purpose is the acquisition or the voting of the shares of the corporation.[49] If such a purpose is shown, the holders of beneficial interests in the entity are treated as shareholders in the corporation for purposes of determining whether there are ten or fewer shareholders in the corporation.[50] Hopefully this rule will eliminate one kind of devious action designed to circumvent the evident statutory policy that close corporation status be confined to corporations with a limited number of participants. One ground on which the Delaware statute has been criticized is that it makes easily available such devices for avoiding the numerical limit for shareholders.[51]

Election of Close Corporation Status

Under the new law, a corporation which satisfies the numerical requirement of ten or fewer shareholders may elect to be treated as a close corporation.[52] The election may be made upon the original formation of the corporation.[53] Presumably at this time all parties are in accord, and will voluntarily agree to the election, though the proposal provides no mechanism for ensuring unanimity or even majority approval at this stage.[54] The election may also be made after the corpo-

47. A.B. 376 § 158(d) (1975).
48. *Id.*
49. *Id.*
50. *Id.*
51. *Delaware's Close Corporation Statute, supra* note 42, at 246.
52. A.B. 376 § 158(a) (1975).
53. *Id.*
54. Commonly, no one is compelled to be a shareholder in a corporation, and therefore there is essentially no need for a statute which prevents a mere majority or any group of fewer than all the participants from imposing close corporation status on potential rather than actual shareholders. The arrangements into which shareholders enter upon formation of close corporations should, however, be governed by general rules of law relating to fraud, duress, and contracts of adhesion. For a discussion in a related area of some troubling policy issues raised by the traditional allowance of the use of nonvoting shares in a publicly held corporation on the theory that all entering shareholders consent to the arrangement, see 1 G. HORNSTEIN, CORPORATION LAW & PRACTICE, § 155 (1959).

ration has been formed by an amendment to the articles.[55] If shares of the corporation have been issued, the amendment must have the unanimous approval of the shareholders.[56] This requirement serves to protect minority shareholders from being unwillingly forced into a corporate structure that they did not contemplate when they originally acquired their shares.[57] The election is made by adding to the articles: 1) the statement: "This corporation is a close corporation;"[58] 2) the words "corporation," "incorporated," or "limited," or an abbreviation thereof in the name of the corporation;[59] and 3) a requirement that all the issued stock of the corporation be held by not more than a specified number of shareholders, not to exceed ten.[60]

Revocation of Close Corporation Election

The election to be treated as a close corporation may likewise be revoked by an amendment of the articles.[61] Section 158(c) of the bill, however, provides that in the case of an amendment to revoke close corporation status, the amendment must be approved by a two-thirds vote of each class of outstanding shares, voting and nonvoting.[62] This requirement may be modified by a provision in the articles of the corporation which authorizes revocation by a greater or smaller fraction of the stock or which excludes any class from the vote.[63] The articles, however, may not provide for less than a majority vote for revocation.[64] Section 158(f) of the bill also expressly authorizes an agreement among the shareholders that they will vote at a later stage to amend the articles to revoke the provisions which give rise to close corporation status.[65]

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55. A.B. 376 § 158(b) (1975).

56. *Id.*

57. *See* O'NEAL, *supra* note 3, § 1.14(c); Bradley, *Toward a More Perfect Close Corporation, supra* note 3, at 1158.

58. A.B. 376 § 158(a) (1975). This provision will largely further administrative convenience in connection with filings in the California Secretary of State's Office. *See* Adickes, *A "Closed Corporation Law" for California*, 54 CALIF. L. REV. 1990, 2003 (1966).

59. A.B. 376 §§ 158(a), 202 (1975). This provision is apparently intended to give some warning to creditors of a close corporation that they are dealing with a corporation and not a partnership. *See* FLA. STAT. ANN. § 608.03(2)(a) (Supp. 1975).

60. A.B. 376 § 158(a) (1975). This section gives rise to the definition of a close corporation as one with no more than ten shareholders. See note 43 & accompanying text *supra.*

61. A.B. 376 § 158(c) (1975).

62. *Id.* Normally, an amendment would take only a majority vote of the outstanding shares of each class entitled to vote. *Id.* §§ 152, 902(a).

63. *Id.* § 158(c).

64. *Id.*

65. *Id.* § 158(f).

The provision allowing for revocation of the close corporation election by a two-thirds vote has been borrowed from the Delaware statute.[66] This specification seems a needless deviation from the requirement of unanimity found in the section dealing with election of close corporation status after formation of the corporation. Allowing a two-thirds majority to revoke the close corporation election ignores the fact that close corporations often find it necessary to protect minority shareholders by providing them with veto powers over certain corporate actions, and it permits such a majority to jeopardize interests of the minority by revoking whenever it chooses.[67]

Forfeiture of Close Corporation Status

In contrast to the perhaps overeasy ability to revoke the close corporation election is the difficulty under the new law of effecting involuntary forfeiture of close corporation status. As mentioned earlier, the only requirement for election of close corporation status is that the corporation have no more than ten shareholders.[68] The transfer of shares to an eleventh shareholder, however, does not normally cause the close corporation to lose its status as a close corporation. Instead, the transfer to the eleventh holder is void if notification to that effect has been placed on the stock certificates.[69] This approach avoids much of the complication of the Delaware statute, which enumerates several conditions to continuing status as a close corporation, allows them to be easily broken, and then, of necessity, establishes elaborate emergency procedures to save the close corporation.[70]

Moreover, the provision that shares held by a trust, partnership, corporation or other business association, except one with the primary purpose of acquiring or voting the shares, are considered held by one shareholder[71] means that changes may be made in the number of beneficiaries within these entities without running the risks of exceeding the

66. DEL. CODE ANN. tit. 8, § 346(a) (1974).

67. This is Professor Bradley's criticism of section 351 of title 8 of the Delaware Code. Section 351, while requiring unanimous consent to an arrangement for shareholder management of a close corporation, permits such a provision to be eliminated by a majority vote. Bradley, *A Comparative Evaluation of the Delaware and Maryland Close Corporation Statutes*, 1968 DUKE L.J. 525, 534, 535 [hereinafter cited as Bradley, *A Comparative Evaluation*]. The proposal perhaps confuses this provision with one allowing easy dissolution of a corporation, a common desire of close corporation participants.

68. See note 43 & accompanying text *supra*.

69. A.B. 376 § 418(c)-(d) (1975). Section 418(c) makes mandatory the placement of a notification of the restriction on transfer on the stock certificates of a close corporation. *Id.* § 418(c).

70. DEL. CODE ANN. tit. 8, §§ 342, 345-49 (1974).

71. A.B. 376 § 158(d) (1975). See notes 48-51 & accompanying text *supra*.

permissible number of shareholders and of thereby making a transfer void.

Forfeiture of close corporation status under the California bill takes place in only four limited situations. First, if the corporation fails to place a notice on its stock certificate to the effect that a transfer to an eleventh shareholder is void, the transfer to an eleventh shareholder is effective and the corporation loses its close corporation status.[72] Second, if a trust, partnership, corporation or business association legitimately holds the stock for a primary purpose other than to circumvent the statute, the termination of such entity and the passing of its stock to other parties terminates close corporation status if, as a result of the transfer, there are more than ten shareholders in the corporation.[73] Third, if a shareholder dies and his stock passes to others by will or intestacy, close corporation status ends if such transfer causes the corporation to have more than ten shareholders.[74] Fourth, if otherwise by operation of law the corporation acquires eleven shareholders, the corporation is no longer a close corporation.[75] Since husband and wife are considered one shareholder, a divorce decree might cause such a forfeiture.

Benefits of Close Corporation Status

The most beneficial effect of election to close corporation status is that the corporation is allowed to function more flexibly in a number of ways. One such way is that all the shareholders of a close corporation may enter into a shareholder agreement pursuant to sections 300(b) & (c) under which they may alter the operations of the corporation without being subject to attack on the ground that their action interferes with the discretion of the board, or that they are attempting to treat the corporation like a partnership or the shareholders like partners.[76] A transferee of the shares of the close corporation is bound by the terms of the agreement if notice of the agreement is placed on the shares and the agreement is filed with the secretary of the corporation for inspection.[77] To the extent that the agreement relieves directors of their managerial duties, liability for failure to observe these duties will be shifted to each of the shareholders who is either a party to the agreement or a transferee bound by its terms.[78]

72. A.B. 376 §§ 158(e), 418(c)-(d) (1975).
73. *Id.* § 158(e).
74. *Id.*
75. *Id.*
76. *Id.* §§ 300(b)-(c). The requirement that all of the shareholders of the close corporation be parties to the agreement is found in the definition of shareholder agreement contained in section 186 of the bill. *Id.* § 186.
77. *Id.* §§ 300(b), 418.
78. *Id.* § 300(d).

A second benefit of close corporation status is that pursuant to section 706(a) shareholders of a close corporation may enter into agreements concerning the voting of their shares which may last for the duration of the close corporation's existence.[79] These agreements may specify how shares are to be voted, or they may provide procedures for making that determination at the time of the vote.[80] Such agreements may involve placing shares in the hands of a third party who is empowered to vote them.[81] A voting trust is the most common of such procedures. Here, too, a transferee of the shares is bound by the terms of the agreement if notice of the agreement is placed on the share certificates.[82]

Finally, section 300(e) of the bill places a limitation on the application of the alter ego doctrine to the shareholders of close corporations who have entered into shareholder agreements pursuant to section 300 (b).[83] Failure to hold meetings of shareholders or directors is not a ground for holding the shareholders personally liable for the obligations of the corporation if they were simply proceeding according to their agreement.[84]

It is apparent that the thrust of the reforms as they relate to close corporations is the allowance of greater contractual freedom to the participants in a close corporation so that they may shape the structure of their business without risking illegality.[85] The remainder of this comment will consider the effectiveness of the California bill in accomplishing this purpose.

Shareholder Agreements Relating to Management of the Corporation

One of the common devices used by shareholders in a close corporation to accomplish their individual purposes is an agreement among themselves concerning management of the corporation's affairs. These agreements may include provisions designating certain persons as officers or employees,[86] specifying the length of the term of employment

79. *Id.* § 706(a).
80. *Id.*
81. *Id.*
82. *Id.* §§ 418(a)(3), (b).
83. *Id.* § 300(e).
84. *Id.*
85. This approach follows the suggestion of Professor Bradley that close corporation statutes should be animated by the principle that the widest possible contractual freedom is to be allowed participants in close corporations. Bradley, *A Comparative Evaluation, supra* note 67, at 525-26.
86. *See, e.g.*, Williams v. Fredericks, 187 La. 987, 175 So. 642 (1937); Seitz v. Michel, 148 Minn. 80, 181 N.W. 102 (1921); McQuade v. Stoneham, 263 N.Y. 323, 189 N.E. 234 (1934).

of those hired,[87] fixing the distribution of the profits of the enterprise,[88] and setting the policies to be pursued in the day-to-day management of the business.[89] In addition, a veto power may be given certain shareholders over particular corporate action.[90] Essentially, these agreements reflect a desire on the part of the shareholders to mold the corporate structure to satisfy more effectively the needs and expectations of the parties, whether these needs and expectations concern a long-term job, a share of the profits not equivalent to capital contribution, or the avoidance of overreaching by the majority shareholders.[91]

Historical Treatment of Shareholder Agreements

Shareholders entering into such agreements in jurisdictions with traditional corporation statutes have been at the same time naive and sophisticated—naive in their presumption that the courts would be friendly to such tampering with the corporate mechanism, and sophisticated in their belief that the observance of certain formalities designed for the protection of shareholders becomes meaningless when none of the shareholders want or desire the protections these formalities afford.[92]

Historically, the courts found these agreements defective on the grounds that they usurped the function delegated the board of directors by the corporation statute and tended to treat the shareholders like partners instead of like participants in a corporation. The typical corporation statute contains a section similar to the present California provision, which states broadly: "all corporate powers shall be exercised by or under authority of, and business and affairs of every corporation shall be controlled by, the board of directors."[93] In Professor Lattin's words, the principle embodied in the statute is that "[t]he management of the modern corporation is almost exclusively in the hands of the board of directors."[94] Directors are normally considered more like principals than like agents in relation to the shareholders.[95] The

87. *See, e.g.*, Williams v. Fredericks, 187 La. 987, 175 So. 642 (1937); Seitz v. Michel, 148 Minn. 80, 181 N.W. 102 (1921).

88. *See, e.g.*, Jackson v. Hooper, 76 N.J. Eq. 592, 75 A. 568 (1910).

89. *Id.*

90. *Cf.* Katcher v. Ohsman, 26 N.J. Super. 28, 97 A.2d 180 (Ch. 1953).

91. 1 O'NEAL, *supra* note 3, § 1.12.

92. Many authorities concur in this belief. *See, e.g.*, 1 O'NEAL, *supra* note 3, § 5.07; Kessler, *The New York Business Corporation Law*, 36 ST. JOHN'S L. REV. 1, 43-67 (1961) [hereinafter cited as Kessler, *New York Law*].

93. CAL. CORP. CODE § 800 (West 1955 & Supp. 1975).

94. LATTIN, *supra* note 16, § 69.

95. Id.

shareholders are traditionally left with little beyond the power to remove the directors whose policies displease them.

In the close corporation, where there exists essentially a unity of the functions of shareholder, director and officer, the results of the application of the general theory to the particular facts have been incongruous. In *Jackson v. Hooper*,[96] two people purchased all the stock of a corporation under an agreement between them that both would serve as directors along with three other "nominal" directors, but that the corporation would be managed as a partnership, with the two of them splitting control and management between themselves. The New Jersey Supreme Court struck down the agreement declaring that the parties could not be partners between themselves and a corporation as to the rest of the world.[97] The court added:

> The law thus confides the business management of the corporation to its directors . . . . They represent all of the stockholders and creditors, and cannot enter into agreements, either among themselves or with stockholders, by which they abdicate their independent judgment.[98]

The Minnesota Supreme Court in *Seitz v. Michel*[99] emphasized the irrelevance of the fact that all of the shareholders had entered an agreement. The court refused to admit evidence of unanimous shareholder agreement and invalidated an agreement between two partners that upon incorporation of their partnership one would provide capital while the other would be guaranteed a lifetime job.

The judicial reluctance to sanction deviations from the corporate norm with regard to the board of directors eventually gave way. The courts, first in recognizing "slight and innocuous" departures from the legal model,[100] and later in declaring that the peculiar needs of the close corporation justified technical violations of the corporation laws,[101] began to accept the validity of shareholder agreements regulating the management of the corporation if they were not characterized by fraud or oppression of minority shareholders.[102] During this period legislatures in a number of jurisdictions, reluctant to leave a matter of such importance to shifting and uncertain judicial thought, expressly sanc-

96. 76 N.J. Eq. 592, 75 A. 568 (1910).

97. *Id.* at 599, 75 A. at 571.

98. *Id.* at 603, 75 A. at 573; *accord*, McQuade v. Stoneham, 263 N.Y. 323, 189 N.E. 234 (1934).

99. 148 Minn. 80, 181 N.W. 102 (1921).

100. Clark v. Dodge, 269 N.Y. 410, 415, 417, 199 N.E. 641, 642, 643 (1936).

101. Galler v. Galler, 32 Ill. 2d 16, 29, 203 N.E.2d 577, 584 (1964).

102. *See, e.g., id.* at 32, 203 N.E.2d at 586; Wilson v. McClenny, 262 N.C. 121, 128, 136 S.E.2d 569, 575 (1964). See also cases cited in 1 O'NEAL, *supra* note 3, § 5.04, but note the author's observation that the courts in some jurisdictions are still unwilling to sanction these arrangements.

tioned arrangements between shareholders, even though the parties treated each other like partners or interfered with the discretion vested in the board of directors.[103]

Present California Attitude

California has not expressed itself clearly with respect to these types of shareholder agreements. The general rule has been stated and applied that the management function of the corporation rests with the board, and that this authority cannot be delegated by means of a shareholder agreement.[104] Moreover, in *Trumbo v. Bank of Berkeley*,[105] the California Court of Appeal indicated that a shareholder agreement could not include a long-term employment contract for a prospective officer because such an arrangement would require the board to relinquish its discretion in selecting officers.

At the same time, however, California has had a provision in its General Corporation Law since 1931 which allows the articles of incorporation to contain provisions not otherwise unlawful for regulating the business and affairs of the corporation, including the function of the directors.[106] Nevertheless, no cited case has invoked this section in considering shareholder agreements regulating the board's function, and little information exists as to how it has been used to incorporate shareholder agreements into the articles. Given the provision's qualification that the agreement be not otherwise unlawful, the statute is probably of little value, since any agreement could still be attacked on grounds sustainable at common law.[107]

The California Bill

Section 300(b) of the California bill allows the shareholders of a close corporaton to enter an agreement regulating the affairs of the corporation including its management, division of its profits, and distribution of its assets on liquidation.[108] Such an agreement would be invulnerable to attack on the ground that it interfered with the discreton of the board or treated the corporation like a partnership or the shareholders like partners.[109] Section 300(c) states that all provisions

103. See statutes cited in 1 O'NEAL, *supra* note 3, § 5.07(a).

104. *See, e.g.*, Kennerson v. Burbank Amusement Co., 120 Cal. App. 2d 157, 171, 260 P.2d 823, 831 (1953); Smith v. California Thorn Cordage, 129 Cal. App. 93, 98, 18 P.2d 393, 395 (1933).

105. 77 Cal. App. 2d 704, 709, 176 P.2d 376, 379 (1947).

106. Cal. Stat. 1931, ch. 862, § 290(7)(c), at 767 (now CAL. CORP. CODE § 305(c) (West 1955)).

107. 1 BALLANTINE & STERLING, *supra* note 35, § 38.

108. A.B. 376 § 300(b) (1975).

109. *Id.*

of the General Corporation Law may be altered or waived by the shareholder agreement except the following: the sections relating to election, revocation, and involuntary loss of close corporation status; the sections regulating dividends and distributions to the shareholders; the sections governing certain votes to be taken by the shareholders of close corporations in connection with mergers and reorganizations; and the chapters relating to corporate records and reports, shareholder inspection of such records, the right to bring an action for involuntary dissolution of the corporation, and criminal penalties.[110]

Section 300(b) is based on a North Carolina statute,[111] and section 300(c) is entirely new. A consideration of the history of the North Carolina statute as well as its judicial treatment is helpful in understanding the thrust as well as the limitations of section 300(b), and also indicates why section 300(c) was included in the proposal as a supplement to 300(b).

The North Carolina Statute

The North Carolina statute defines a close corporation as one whose shares are not publicly traded, and it provides that unanimous agreements among the shareholders of such close corporations are not subject to attack on the ground that they treat the corporation like a partnership or the shareholders like partners.[112] In addition, all or less than all the shareholders of any corporation as well as nonshareholders may enter into agreements which cannot be invalidated on the basis that they interfere with the discretion of the board.[113]

While the language of the North Carolina statute is clearly directed at correcting the mistaken views of the courts that led to the statute's enactment, this approach causes the statute to suffer from a certain amount of shortsightedness. Under the statute shareholder agreements are free from attack on the same three grounds enumerated in the California measure. Nonetheless, what is to prevent an ingenious attorney from inventing other grounds on which to attack such an agreement? For example, he could allege that the agreement eliminated the board of directors rather than just interfered with its discretion,[114] or that its provisions constituted an unreasonable restraint

110. *Id.* § 300(c).

111. N.C. GEN. STAT. § 55-73(c) (1975).

112. *Id.* § 55-73(b).

113. *Id.* § 55-73(c). The original draft of the California proposal permitted less than unanimous shareholder agreements interfering with the board's discretion in close corporations. *See* 1 STATE BAR OF CALIFORNIA COMMITTEE ON CORPORATIONS, EXPOSURE DRAFT: GENERAL CORPORATION LAW § 300(b) (1974). Later revisions allowed such agreements only if unanimous shareholder assent to them was obtained. *See* A.B. 376 § 300(b) (1975).

114. Professor Kessler indicates that a shareholder agreement could not eliminate

on the alienation of property[115] or conflicted with a statutory guarantee of cumulative voting in the election of directors.

Professor Latty perhaps anticipated this criticism, and in a comment made shortly after the statute's enactment, he indicated that the essential purpose of the statute was to "set a friendly tone for incorporated partnership arrangements."[116] He went on to point out that the statute was phrased in the negative to allow greater judicial freedom and flexibility, and that its essential thrust was to make clear that no agreement between shareholders should be held invalid merely because it treated the corporation like a partnership.[117] He did admit, however, that "[a] court may pronounce [an agreement] bad for other reasons, although it would presumably have to be something pretty serious since it was agreed to by everyone.[118]

In a case dealing with the same statute, the North Carolina Supreme Court failed to show an attitude toward close corporations as friendly as Professor Latty might have hoped. In *Stein v. Capital Outdoor Advertising, Inc.*,[119] the court considered an agreement between two of three shareholders of a corporation under which one allowed the other to vote his stock. The shareholder given the vote attempted to use this power to oust the other two shareholders from the board of directors. Perhaps influenced by the overreaching of the shareholder who was given the vote of the shares, the court threaded its way cautiously through the liberalizing provisions of the North Carolina Business Corporations Act and finally found the agreement to be a proxy which had expired, since under North Carolina law, a proxy could be granted for a maximum of eleven months.[120] In particular the court rejected the argument that the agreement should be upheld under the North Carolina provision protecting less than unanimous shareholder agreements from attack on the ground that they interfered with the discretion of the board.[121] Rather than recognizing a penumbra surrounding the statute in favor of close corporation agreements, the court simply stated that the statute could not uphold the agreement because

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the board under a similar New York statutory pattern. *See* Kessler, *New York Law, supra* note 92, at 49.

115. For a discussion of how a shareholder agreement under section 300(b) might permissibly extend to share transfer restrictions and thus raise problems of restraint on alienation, see notes 165-191 & accompanying text *infra.*

116. Latty, *The Close Corporation and the New North Carolina Business Corporations Act*, 34 N.C.L. REV. 432, 438 (1956).

117. *Id.* at 439.

118. *Id.*

119. 273 N.C. 77, 159 S.E.2d 351 (1968).

120. *Id.* at 84, 159 S.E.2d at 356.

121. *Id.*

the agreement did not by its terms infringe on the discretion of the board, and "all that [section] 55-73(c) does is to remove an agreement between stockholders from that specific objection to its validity."[122]

The case indicates that the flexibility placed in the North Carolina statutes gives a court the freedom to interpret the statutory reprieve in very narrow terms. Furthermore, this result suggests once more the possibility that grounds not stated in the statute could be used to overthrow a shareholder agreement.

Section 300(b): *Its Scope and Limitations*

Section 300(b) of the bill, having been drawn in large part from this North Carolina statute, suffers from a similar lack of precision. Thus, from its terms, it is likewise unclear how far a shareholder agreement may go in restructuring the corporation. It, too, is phrased in the negative, stating on what grounds shareholder agreements cannot be attacked.[123] As in the case of the North Carolina statute, it does not positively endorse the legality in all circumstances of any type of close corporation shareholder agreement. Therefore, the courts are free to interpret the statute as sanctioning virtually all close corporation agreements, perhaps with an exception for agreements procured by fraud, or to interpret it as simply providing a limited protection for shareholder agreements, upholding them only in those cases in which the attack is explicitly proscribed by the statute.

As indicated above, section 300(b) does explicitly bring within the scope of its uncertain protection three types of shareholder agreements. The first type, that relating to the management of the affairs of the corporation, is so inclusive that it provides no further guidance beyond the general terms of 300(b) as to what is a permissible shareholder agreement.[124] The second type, agreements relating to the division of profits, is limited by the express qualification in section 300 (c) that a shareholder agreement under section 300(b) may not alter the provisions of the new General Corporation Law regulating dividends and other distributions to the shareholders.[125] Thus, this type of agreement seems to be limited to one providing that dividends lawfully declared be distributed on a basis other than the number of shares held by each particular shareholder. Since such a disproportionate division of profits can presently be accomplished by artful use of pre-

122. *Id.*
123. A.B. 376 § 300(b) (1975).
124. *Id.*
125. *Id.* § 300(c), 500, 501.

ferred and common shares, the proposal appears merely to allow a simpler and more direct means to such distribution within a close corporation without adding much to the substantive rights of close corporation shareholders.

Finally, section 300(b) refers to agreements concerning the distribution of the assets of the corporation on liquidation.[126] Narrowly read, this provision could be viewed as nothing more than a codification of existing case law relating to the establishment of preferences on liquidation.[127] More broadly read, however, it could be viewed as providing explicit authorization for agreements relating to the liquidation of the corporation which would allow one or more shareholders to elect to dissolve the corporation regardless of whether or not they held fifty percent or more of the voting power of the corporation as required by section 1900 of the bill.[128] In any event, this reference, as well as the other two explicit references within 300(b), must be read against the uncertain backdrop of 300(b) as a whole, which validates close corporation shareholder agreements only in an indirect, negative manner.

Section 300(c) *and its Relation to Section* 300(b)

Section 300(c) attempts to remedy the defects in 300(b) by articulating a broad based affirmation of the contractual freedom of shareholders party to a 300(b) agreement.[129] Nevertheless, the sentence in 300(c) declaring that all of the provisions of the General Corporation Law other than those specifically mentioned in 300(c) can be altered or waived was an amendment to the bill as originally submitted and fails to blend with the other parts of section 300.[130]

For example, section 300(b) is an express qualification of section 300(a), which states that the corporation is to be managed by the board.[131] Section 300(b) upholds a unanimous shareholder agreement which interferes with the managerial discreton of the board of directors. Standing alone, section 300(b) seems to contemplate a board whose function may be limited, but not eliminated, by a shareholder agreement.[132] In light of this express treatment of the relation

126. *Id.* § 300(b).

127. For a discussion of shareholder agreements relating to liquidation of the corporation under present California law see Comment, *Rights of Minority Shareholders to Dissolve a Closely Held Corporation*, 43 CALIF. L. REV. 514 (1955).

128. Section 1900 governs the election by the shareholders to voluntarily dissolve their corporation. A.B. 376 § 1900 (1975).

129. *Id.* § 300(c).

130. Parts of A.B. 376, including section 300(c), were amended in the California Assembly on April 1, 1975.

131. A.B. 376 §§ 300(a)-(b) (1975).

132. It is not entirely clear that the board could not be abolished by an agreement

between shareholder agreement and board in 300(b), it remains open to question whether or not 300(c) could be interpreted to allow complete abolition of the board. This conclusion finds support in the fact that an agreement under 300(c) can waive the provisions of the Corporation Law only if it qualifies under 300(b).[133]

An inspection of section 300(d) indicates further limitations on section 300(c). Section 300(d) shifts liability to the shareholders who are parties to a 300(b) agreement to the extent the directors are relieved of their responsibilities.[134] It seems improbable that by virtue of 300(c) the shareholders could eliminate the liability imposed upon them by 300(d) and leave such liability imposed on a group of dummy directors who could then disclaim responsibility because they were powerless to act by reason of the shareholder agreement. Nevertheless, the express terms of 300(c) would seem to allow the shareholders to take this action.

Finally, it seems that it would be impossible for shareholders to use section 300(c) to alter section 300(e) at all. Section 300(e) provides a limited statutory reprieve from the application of the judicially developed alter ego doctrine.[135] Since 300(c) allows the alteration or waiver only of statutes and not of case law, any tinkering with 300(e) could only mean a less extensive reprieve than the section would otherwise allow.

Thus, the broad and ill-defined grant of 300(c) has introduced ambiguities even within the narrow context of section 300. Even greater uncertainty is likely to attend the application of 300(c) to the corporation law as a whole, and it remains problematic whether or not a court would be willing to allow a shareholder agreement to eliminate such controversial provisions of the new General Corporation Law as those limiting indemnification of the board of directors by the corporation,[136] those providing for the rights of dissenters concerning fundamental

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under A.B. 376 section 300(b). The language of the statute is equivocal, however, and since it would have been simple enough to state that the board could be abolished, the absence of such permission indicates at least a legislative disinclination toward such abolition. Professor Bradley indicates that similar equivocal language in a South Carolina statute was intended to discourage shareholders from abolishing the board. Bradley, *Toward a More Perfect Close Corporation, supra* note 3, at 1178-80. Professor Kessler states that a New York statute allowing agreements which interfere with the discretion of the board does not allow abolition of the board. *See* Kessler, *New York Law, supra* note 92, at 49.

133. A.B. 376 § 300(c) (1975).

134. *Id.* § 300(d).

135. *Id.* § 300(e). See also notes 244-49 & accompanying text *infra.*

136. A.B. 376 § 317 (1975).

corporate action,[137] and those relating to interested directors' dealings with the corporation.[138]

Moreover, despite its freewheeling approach, section 300(c) fails to give sanction to one of the most meaningful elements of a close corporation agreement, the stock transfer restriction. Since, as will be discussed below, the legal difficulties of stock transfer restrictions arose from common law hostilities to restraints on the alienation of property,[139] allowing shareholder agreements to waive or alter provisions of the General Corporation Law in no way removes the legal impediments to stock transfer restrictions.

It is disappointing that the California proposal, while recognizing the important right of shareholders in a close corporation to fashion the structure of the corporation according to their unanimous agreement, is not more explicit in dealing with the validity and scope of such agreements. Maryland provides an interesting counterbalance. The Maryland statute dealing with shareholder agreements in a close corporation specifically enumerates the areas to which the agreement may extend, and also makes clear that the board of directors can be abolished.[140] Similarly, Rhode Island's statute, though by no means as clear as Maryland's, states explicitly that the agreement may abolish the board of directors.[141]

Share Transfer Restrictions

Purposes and Kinds of Share Transfer Restrictions

A common desire of participants in a close corporation is that the business entity have the characteristic of *delectus personarum* commonly associated with partnerships; that is, that the associates in the business have the power to choose those with whom they will work and to exclude those with whom they do not wish to work.[142] Stock transfer restrictions are common devices to this end.[143] Limitations on the manner in which the stock can pass from the hands of the original participants help both to preserve the original membership and form of the organization and, if that membership and form are to change, to give the remaining participants a voice in determining to whom the

137. *Id.* §§ 1300-12.

138. *Id.* § 310.

139. See notes 148-51 & accompanying text *infra.*

140. MD. ANN. CODE art. 23, §§ 103, 104 (1967).

141. R.I. GEN. LAWS ANN. § 7-1.1-51 (1969).

142. 1 O'NEAL, *supra* note 3, § 1.12; Kessler, *Partnership Corporation, supra* note 34, at 256.

143. Professor O'Neal estimates that one-half of the corporations in the United States have placed transfer restrictions on their shares. 2 O'NEAL, *supra* note 3, § 7.03 at 6 n.5.

shares will be transferred.[144] Share transfer restrictions can take any of the following forms:

1) an absolute prohibition on the transfer of stock;

2) a consent restriction requiring that the holder of the shares obtain the consent of the corporation or other shareholders before he can sell his stock;

3) a right of first refusal, by which the corporation or one or more of its shareholders must be offered the stock, and must be given the opportunity to buy it, before a sale to outsiders is permitted; or

4) a buy-out agreement, which imposes an obligation on the corporation or its shareholders to purchase the stock, and on its holder to sell it, on the occurrence of a stated event or contingency, commonly death of the holder or his retirement from the business.[145]

As Professor O'Neal indicates, this catalogue of restrictions is somewhat misleading, for differing aspects of the four common types of transfer restrictions actually allow for an infinite variety of restrictions.[146] The enumerated types do, however, form the parameters within which most restrictions could conceivably be drawn.[147]

Judicial Treatment of Share Transfer Restrictions

Given the hostility of American courts to restraints on the alienation of property, absolute prohibitions on the transfer of stock have rarely been attempted in the United States, and the courts have made clear that they will consistently invalidate any such provisions.[148] Con-

144. *See* Tu-Vu Drive-In Corp. v. Ashkins, 61 Cal. 2d 283, 287, 391 P.2d 828, 830, 38 Cal. Rptr. 348, 350 (1964); 12 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 5461.1 (rev. ed. 1971); 1 O'NEAL, *supra* note 3, § 1.12; Bradley, *Stock Transfer Restrictions and Buy-Sell Agreements*, 1969 U. ILL. L.R. 139 [hereinafter cited as Bradley, *Stock Transfer Restrictions*]. Another advantage of such restrictions is that they enable the corporation to qualify for exemptions from registration under federal and state securities laws. *See, e.g.*, Securities Act of 1933, §§ 3, 4, 15 U.S.C. 77c, 77d (1970); CAL. CORP. CODE § 25102(h) (West Supp. 1975).

145. 1 BALLANTINE & STERLING, *supra* note 35, at § 46; 12 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 5461.1 (rev. ed. 1971); 2 O'NEAL, *supra* note 3, § 7.05.

146. 2 O'NEAL, *supra* note 3, § 7.05.

147. *See* Bradley, *Stock Transfer Restrictions, supra* note 144, at 140-42.

148. *See* Allen v. Biltmore Tissue Corp., 2 N.Y.2d 534, 542, 141 N.E.2d 812, 816, 161 N.Y.S.2d 418, 423 (1957) (dictum); Farmer's Mercantile & Supply Co. v. Laun, 146 Wisc. 252, 256, 131 N.W. 366, 368 (1911) (dictum); 2 O'NEAL, *supra* note 3, § 7.06; Annot., 61 A.L.R.2d 1318 (1958); Annot., 65 A.L.R. 1159, 1165 (1930). *But see* Carpenter v. Dummit, 221 Ky. 67, 297 S.W. 695 (1927).

sent provisions have fared poorly for the same reason.[149] While some courts have upheld them as reasonable restraints, others have disallowed them, contending that they place unbridled power in the hands of the party whose consent is required.[150] Thus, rights of first refusal, buy and sell agreements, and modified prohibitions limiting the class to whom the stock may be transferred have been the common means for placing restraints on the transfer of stock.[151]

Stock Transfer Restrictions Under California Law

The present California Corporations Code provides that reasonable restrictions on the transfer of stock may be embodied in the bylaws of the corporation.[152] The new law modifies this permission slightly by allowing such restrictions to be placed in either the articles or the bylaws.[153]

In interpreting the present statute, the California Supreme Court in *Tu-Vu Drive-In Corp. v. Ashkins*[154] held that the provision which requires that a bylaw imposing a transfer restriction be reasonable suggests a two-fold test: 1) that the bylaw must not constitute an unreasonably restrictive curtailment of the right of alienation; and 2) that it must not otherwise unreasonably deprive the shareholder of substantial rights.[155]

The restraint imposed on the shareholder in *Tu-Vu* required that before selling her stock she offer it to the corporation at the price at which she planned to sell it. The court balanced the interests of the corporation against those of the shareholder to determine the reasonableness of the restriction under the test. Given the mildness of the restraint and the fact that such restrictions were often essential to the corporation in preventing unwanted intrusion by outsiders, as well as in preserving the integrity of the entity, the court found the restriction

149. *See* Bradley, *Stock Transfer Restrictions, supra* note 144, at 140-42; Painter, *Stock Transfer Restrictions: Continuing Uncertainties and A Legislative Proposal*, 6 VILL. L. REV. 48 (1960).

150. *See, e.g.*, Tracey v. Franklin, 31 Del. Ch. 477, 67 A.2d 56 (1949) (invalid); Morris v. Hussong Dyeing Mach. Co., 81 N.J. Eq. 256, 86 A. 1026 (1913) (invalid); Rafe v. Hindin, 23 N.Y.2d 759, 296 N.Y.S.2d 955, 244 N.E.2d 469 (1968) (invalid). *But see, e.g.*, Schaffer v. Below, 278 F.2d 619 (3d Cir. 1960) (valid); Carlson v. Ringold County Mut. Tel. Co., 252 Iowa 748, 108 N.W.2d 478 (1961) (valid); Barrett v. King, 181 Mass. 476, 63 N.E. 934 (1902) (valid).

151. *See* 2 O'NEAL, *supra* note 3, § 7.05; Bradley, *Stock Transfer Restrictions, supra* note 144, at 140-41.

152. CAL. CORP. CODE § 501(g) (West 1955).

153. A.B. 376 §§ 204(b), 212(b)(1) (1975).

154. 61 Cal. 2d 283, 391 P.2d 828, 38 Cal. Rptr. 348 (1964).

155. *Id.* at 286, 391 P.2d at 830, 38 Cal. Rptr. at 350.

reasonable.[156] In dictum in a later case, Justice Traynor summarized the grounds for finding the restriction reasonable in *Tu-Vu*: "A corporation can restrict the transfer of its shares because of the interest of the shareholders in the persons with whom they are in business."[157]

The holding in *Tu-Vu* must not be read too broadly, however. While the decision appears to give broad sanction to stock transfer restrictions which enable the participants in a close corporation to determine with whom they will work, the court carefully considered the particular type of restriction imposed and emphasized that under the agreement in *Tu-Vu*, the shareholder was merely required to make a first offer to the corporation and its shareholders; she did not have to accept anything less from them than the price she planned to ask of outsiders.[158]

In short, California appears to be no friendlier to share transfer restrictions than are most other jurisdictions. Despite the concern of the court in *Tu-Vu* for the needs of the close corporation, and the willingness suggested in other recent decisions to uphold rights of first refusal,[159] the California courts have not explicitly upheld absolute transfer prohibitions or consent restraints, and thus close corporation participants remain in doubt as to the legality of restrictions more stringent than rights of first refusal. This uncertainty persists despite the fact that consent restraints and absolute transfer prohibitions are probably the most effective tools for close corporations desiring to restrict their membership.

Part of the problem is that the courts have been presented with

156. *Id.* at 287, 391 P.2d at 830, 38 Cal. Rptr. at 350. The restraining bylaw the court upheld as reasonable was passed after the complaining shareholder acquired her shares. To the extent that the court permitted the bylaw to apply retroactively against the shares outstanding without the consent of the holders, the case is legislatively overruled by sections 204 and 212 of the new law, which provide that restrictions on transfer contained in the articles or bylaws shall not be binding "with respect to shares issued prior to the adoption of the restriction unless the holders of such shares voted in favor of the restriction." A.B. 376 §§ 204(b), 212(b)(1). The court's standard of reasonableness for judging the validity of bylaws restricting transfer is not overruled by the new law, however, since that standard has been applied to such bylaws irrespective of whether or not they operated retroactively. For cases discussing the applicability of the standard to prospectively applied bylaws, see Yeng Sue Chow v. Levi Strauss & Co., 49 Cal. App. 3d 415, 122 Cal. Rptr. 816 (1975); Sanchez v. Centro Mexicano, 1 Cal. App. 3d 756, 81 Cal. Rptr. 875 (1969).

157. Coast Bank v. Minderhout, 61 Cal. 2d 311, 316, 392 P.2d 265, 268, 38 Cal. Rptr. 505, 508 (1964).

158. Tu-Vu Drive-In Corp. v. Ashkins, 61 Cal. 2d 283, 287, 391 P.2d 828, 830, 38 Cal. Rptr. 348, 350 (1964).

159. *See, e.g.*, Sanchez v. Centro Mexicano, 1 Cal. App. 3d 756, 81 Cal. Rptr. 875 (1969) (right of first refusal held valid); Casady v. Modern Metal Spinning & Mfg. Co., 188 Cal. App. 2d 728, 10 Cal. Rptr. 790 (1961) (right of first refusal held valid).

a statute which in upholding "reasonable" restraints fails to distinguish between closely held and public corporations. Thus, the courts may be reluctant to venture too far in allowing members of close corporations to impose such restraints for fear that this result would present an opportunity for mischief by those in control of publicly held corporations. A more realistic explanation[160] may be that the courts are simply unwilling to view the statute as a close corporation statute absent a clearer indication of legislative intent supporting such an interpretation.

The California Bill

Three parts of the California bill potentially relate to the problems of share transfer restrictions and the close corporation. Section 204(b) allows the articles of the corporation to set forth reasonable restrictions on the transfer of stock.[161] This provision is drawn verbatim from the old statute except that the new law adds that such a provision cannot be given retroactive effect over shares already issued unless those holding the shares voted for the restriction, and that the articles as well as the bylaws may contain such restrictions.[162] The enactment of this section thus merely incorporates into the new General Corporation Law the problems left unresolved by the old statute, since the section does not affect the uncertain availability of consent and absolute prohibition restraints and fails to distinguish between close and public corporations.[163]

The second aspect of the bill which may assist the participants in a close corporation in their attempts to restrict transfers is its specification that a close corporation's articles must limit the corporation to ten or fewer shareholders and that a transfer is void that would result in the corporation having more shareholders than the number stated in the articles.[164] While the outer limit set by the articles may help to

160. That the first explanation may not be realistic is demonstrated by the fact that almost all the appellate cases in which the courts have dealt with share transfer restrictions have involved corporations that would qualify as close corporations under the proposal. *See, e.g.*, Tu-Vu Drive-In Corp. v. Ashkins, 61 Cal. 2d 283, 391 P.2d 828, 38 Cal. Rptr. 348 (1964) (three shareholders in corporation); Vanucci v. Pedrini, 217 Cal. 138, 17 P.2d 706 (1932) (five shareholders in corporation); Casady v. Modern Metal Spinning & Mfg. Co., 188 Cal. App. 2d 728, 10 Cal. Rptr. 790 (1961) (three shareholders in corporation). *But see* Sanchez v. Centro Mexicano, 1 Cal. App. 3d 756, 81 Cal. Rptr. 875 (1969) (stock apparently widely held).

161. A.B. 376 § 204(b) (1975).

162. *Id.*

163. See notes 152-60 & accompanying text *supra.*

164. A.B. 376 §§ 158(a), 418(c)-(d) (1975).

ensure the size corporation the shareholders desire, the thrust of the statute is more clearly aimed at serving the legislative policy of restricting the benefits of close corporation status to small businesses, since within the limit set by the articles the shares are freely transferable. Thus, while the number of shareholders in the corporation could be limited by means of the statement in the articles, the desire of the participants to choose those with whom they work would be only partially met.

Application of Section 300(b)

The third and final aspect of the bill that may relate to stock transfer restrictions is section 300(b), which authorizes unanimous shareholder agreements in close corporations.[165] If it applies to share transfer restrictions, 300(b) would relate only to restrictions within close corporations and would not burden the courts with the problems such restrictions might pose within publicly held corporations. Furthermore, application of 300(b) to share transfer restrictions would comport with the apparent policy of the statute to promote contractual freedom among the participants in a close corporation.

The initial stumbling block in applying 300(b) to agreements to restrict the transfer of stock is that the section does not by its terms explicitly extend to such agreements. Moreover, the section is located in the part of the new General Corporation Law dealing with the board of directors and its function in the corporation. Thus, it is perhaps more consistent with this positioning to conclude that while 300(b) states that agreements among all shareholders of a close corporation may relate to "any phase of the affairs of a close corporation," it is essentially concerned with allowing alternative arrangements for the day to day operation of the close corporation and fails to sanction agreements such as stock transfer restrictions, which relate to the structure within which management operates and the ownership interests in the corporation.[166]

The section's enumeration of the "affairs" to which such an agreement may extend, however, belies this result. The agreement can relate not only to management of the business and division of its profits, but also to "distribution of its assets on liquidation."[167] Liquidation

165. *Id.* § 300(b).

166. Professor Latty, in his analysis of the North Carolina statute upon which section 300(b) of the California proposal is based made clear that he felt the statute did not extend to include agreements to restrict the transfer of stock. *See* Latty, *The Close Corporation and the New North Carolina Business Corporation Act*, 34 N.C.L. REV. 432, 450 (1956).

167. A.B. 376 § 300(b) (1975).

agreements involve structural changes in the corporation and affect its continuity. They have little to do with the day to day operation of the business and are particularly unrelated to the ordinary function of the board of directors. A restrictive interpretation of 300(b) which would limit it to agreements relating to the management activities of the board is therefore inappropriate and, by analogy to liquidation agreements, agreements restricting the transfer of stock could easily be included within the scope of 300(b).

Protection 300(b) *Could Afford*

If 300(b) does apply to share transfer restriction agreements, a further question arises concerning the degree of protection which the provision would afford such agreements. As discussed above, section 300(b) protects a shareholder agreement formed pursuant to its terms from attack on the ground that the agreement treats the corporation as if it were a partnership or interferes with the discretion of the board of directors.[168] Presumably, to the extent that it contained a stock transfer restriction, an agreement could still be attacked on the ground that it constituted an unreasonable restraint on the alienation of property. This vulnerability could in turn mean that stock transfer restrictions imposed pursuant to 300(b) would receive no different treatment than that afforded bylaws restricting transfer under present general corporation law.[169]

If 300(b) is viewed more liberally, however, it can be said that stock transfer restrictions amount to treating the corporation like a partnership, since such agreements can give shareholders a voice in the admission of new participants, a power always possessed by partners.[170] If this interpretation of section 300(b) is accepted, the section could be viewed as giving blanket authorization to any restriction, no matter how severe, since the essence of the partnership arrangement is that no partner is free to transfer his right to participate in the partnership simply by his own independent action and that partners are always free to agree that their interests cannot be transferred.[171] This interpretation may go too far, however, and may read into the statute more than it was intended to provide.

168. See notes 108-41 & accompanying text *supra*.

169. See notes 148-60 & accompanying text *supra*.

170. *See* J. CRANE & A. BROMBERG, LAW OF PARTNERSHIP § 42, at 239 (1968). While a partner is free to assign his interest at any time, absent a contrary agreement among the partners, his assignee will not become a partner without the consent of the other partners. The assignee will, however, succeed to the assigning partner's share of the profits and of any surplus remaining on dissolution. *Id.*

171. *Id.*

A position midway between those explained above is that section 300(b) indicates, in general, an intent by the legislature to allow the participants in close corporations greater freedom than presently exists in fashioning the business form within which they will work. In line with this interpretation, the statute should be viewed as authorizing more severe share transfer restrictions in 300(b) shareholder agreements than are allowed in the articles or bylaws of a non-close corporation, though perhaps less severe restrictions than those permitted in a partnership. Thus, even though a restriction might be unenforceable as too restrictive if placed in the articles or bylaws, it could be upheld under 300(b) as a contract between the close corporation participants.

This interpretation of 300(b) would correspond to the recognition in an old line of California cases that a transfer restriction invalid as a bylaw because it placed an unreasonable restraint on alienation could still be enforced between the parties as a contract.[172] Presumably the distinction drawn in these cases derives from English law, which early emphasized the contractual nature of the constitution of the corporation.[173] If this reasoning is followed, once a contract restricting transfer is found to exist, restraints contained therein are imposed on those who knowingly assent to its terms, even though the restraint as a bylaw is unenforceable.[174]

Vanucci v. Pedrini[175] offers the clearest exposition of this rule. In that case, the California Supreme Court faced a bylaw giving a right of first refusal to both the corporation and its shareholders to purchase at book value the stock held by the defendant, if at any time he decided to sell it to an outsider. Three previous appellate decisions had considered the validity of similar share transfer restrictions imposed by the bylaws of one California corporation.[176] In each case, the court held the bylaw invalid, the final time because the transferee had not re-

172. *See* Vanucci v. Pedrini, 217 Cal. 138, 17 P.2d 706 (1932); Smith v. San Francisco & N. Pac. Ry., 115 Cal. 584, 605, 47 P. 582, 589 (1897); Oakland Scavenger Co. v. Gandi, 51 Cal. App. 2d 69, 81, 124 P.2d 143, 150 (1942); Bodkin v. Silveira, 49 Cal. App. 2d 1, 5, 120 P.2d 910, 912 (1942). *But see* Scott v. Lee, 208 Cal. App. 2d 12, 24 Cal. Rptr. 824 (1962).

173. *See* Gower, *Some Contrasts Between British and American Corporation Law*, 69 HARV. L. REV. 1369, 1376-78 (1956); Note, *Corporations—Close Corporate Shareholder's Right to Transfer Shares May Be Restricted Without His Consent, Tu-Vu Drive-In Corp. v. Ashkins (Cal. 1964)*, 53 CALIF. L. REV. 692 (1965).

174. *See* Vanucci v. Pedrini, 217 Cal. 138, 17 P.2d 706 (1932); Smith v. San Francisco & N. Pac. Ry., 115 Cal. 584, 605, 47 P. 582, 589 (1897); Oakland Scavenger Co. v. Gandi, 51 Cal. App. 2d 69, 81, 124 P.2d 143, 150 (1942); Bodkin v. Silveira, 49 Cal. App. 2d 1, 5, 120 P.2d 910, 912 (1942).

175. 217 Cal. 138, 17 P.2d 706 (1932).

176. Mancini v. Patrizi, 110 Cal. App. 42, 293 P. 828 (1930); Mancini v. Patrizi, 87 Cal. App. 435, 262 P. 375 (1927); Mancini v. Setaro, 69 Cal. App. 748, 232 P. 495 (1924).

ceived notice of the bylaw. In attempting to distinguish these previous cases from the one before it, the court emphasized that the party who had attempted to purchase the stock had had full notice of its terms, and that the bylaw, even if unenforceable against a non-assenting shareholder, could be interpreted as a contract binding on all those who assented to its terms. The party attempting to purchase the stock was held to have manifested her agreement to the restriction by taking the stock with notice of the restriction.[177]

Today, such a mild restriction would probably be enforced as a valid bylaw.[178] The decision is nonetheless instructive, as it reveals a large residuum of California decisional law which allows contractual provisions restricting share transfers even though they go considerably beyond the restrictions which can be contained in a corporation's articles or bylaws. Although the early cases are in some respects confusing, they have validated the following restrictions under the contract theory: a right of first refusal in the corporation and its shareholders,[179] the surrendering by assenting shareholders of the right to make testamentary disposition of their stock,[180] an agreement not to transfer stock for a period of 5 years unless assent to be bound by a voting agreement was first obtained from the transferee,[181] a restriction requiring the holder of stock in a bank to pay all indebtedness due the bank before he could transfer his stock,[182] and a provision that the shares in a water company would remain tied to the land served by the company.[183]

These cases suggest that the courts are more willing to uphold drastic transfer restrictions when the restrictions are contained in contracts rather than provided in bylaws. Section 300(b) involves shareholder contracts, and if the section extends to contracts restricting transfer of stock, these cases indicate that greater flexibility should be allowed as to the types of restraints these agreements may impose than is allowed for share transfer restrictions contained in bylaws or articles. Since the benefits of section 300(b) are confined to close corporations, this interpretation would promote the judicially recognized needs of close corporation participants without opening the door to abuse by publicly held corporations. This interpretation of 300(b) would also

177. Vanucci v. Pedrini, 217 Cal. 138, 143, 17 P.2d 706, 708 (1932).

178. See text accompanying notes 151-60 *supra.*

179. Vanucci v. Pedrini, 217 Cal. 138, 17 P.2d 706 (1932); Bodkin v. Silveira, 49 Cal. App. 2d 1, 120 P.2d 910 (1942).

180. Oakland Scavenger Co. v. Gandi, 51 Cal. App. 2d 69, 81, 124 P.2d 143 (1942).

181. Smith v. San Francisco & N. Pac. Ry., 115 Cal. 584, 605, 47 P. 582, 589 (1897).

182. Jennings v. Bank of California, 79 Cal. 323, 326-27, 21 P. 852, 853 (1889).

183. Riverside Land Co. v. Jarvis, 174 Cal. 316, 326-27, 163 P. 54, 58 (1917).

make California close corporation law more compatible with British law, from which the distinction between permissible bylaws and enforceable contracts was originally derived. Under British law, the contractual theory as to stock transfer restrictions has influenced the statutes regulating the forms which businesses may take, with the result that a company formed under the Private Company Act (the equivalent of an American close corporation statute) *must* restrict the transfer of its shares.[184] Similarly, under the contractual theory developed in the California cases, a greater permissibility regarding such restrictions could be allowed in the case of unanimous shareholder agreements in close corporations under section 300(b).

Notice Provisions of Section 300(b)

In addition to possibly allowing more stringent transfer restrictions than are presently permitted, section 300(b) provides for a system of constructive notice to prospective purchasers and thereby could make enforceability of shareholder agreements to restrict transfer much easier. The California cases indicate some ambivalence as to who, other than the original parties to a transfer restriction agreement, may presently be bound by its terms.[185] It is clear, however, that at least the party purchasing the stock must have actual knowledge of the restriction to be bound by it.[186]

In contrast, 300(b) provides that if the agreement is filed with the secretary of the corporation for inspection by prospective purchasers of the stock, and if a notation is made on the stock pursuant to section 418 of the bill that the shares are subject to a shareholder agreement, a purchaser, even one who does not have actual knowledge of the restriction, is bound by the terms of the agreement.[187] A party who purchases with actual knowledge of the agreement is bound by

184. Companies Act of 1948, 11 & 12 Geo. 6, c. 38, § 28(1). See Gower, *Some Contrasts Between British and American Corporation Law*, 69 HARV. L. REV. 1369, 1377-78 (1956).

185. *Compare* Vanucci v. Pedrini, 217 Cal. 138, 17 P.2d 706 (1932) (indicating that a purchaser of the stock is bound by a restriction if he takes with notice of it) *with* Jennings v. Bank of California, 79 Cal. 323, 293 P. 852 (1889) (holding a purchaser bound by a restriction only after finding an implied assent to the restriction from his conduct).

186. *See* Mancini v. Patrizi, 110 Cal. App. 42, 293 P. 828 (1930).

187. A.B. 376 §§ 300(b), 418(c) (1975). Present California law does not explicitly provide that an agreement restricting transfer can be made binding on subsequent purchasers by notation on the stock certificate if the agreement is merely a private contractual arrangement between shareholders and the restriction is not the consequence of some form of corporate action. *Compare* CAL. CORP. CODE § 2404 (West 1955) *with* CAL. COMM. CODE § 8204, comment 4 (West 1964).

it regardless of whether or not a notation of the agreement is made on the stock. Section 300(b) could furnish a convenient device for the imposition of more stringent controls upon the transfer of a close corporation's stock.

Nevertheless, as mentioned earlier, application of 300(b) to agreements restricting the transfer of stock raises two problems: it is not clear that the section was intended to cover such agreements, and even if it does extend to such agreements, it is not clear that restrictions embodied in these agreements could be any more strict than those allowed under the general corporation law. The imposition of stock transfer restriction in a close corporation is normally not an occasion for inventiveness and imagination.[188] The parties normally want a provision which will accomplish their purpose and at the same time run the least risk of being found illegal. Thus it is likely, in light of the uncertainties surrounding 300(b), that the participants in close corporations will adhere to the existing law when they draft stock transfer restrictions.

Other states' attempts at revision demonstrate that uncertain coverage of share transfer restrictions is not an inevitable result of a provision such as 300(b). Rhode Island also follows the North Carolina statute that serves as a basis for California's new section 300(b).[189] Nevertheless, that state resolved any ambiguity as to the application of the section to stock transfer restrictions by adding the stipulation that an agreement among all the shareholders, whether embodied in the articles or not, is not to be held invalid on the ground that it "imposes too great a restraint on the transfer of the shares of the corporation."[190] Under Rhode Island law, then, any restriction, no matter how absolute, on the transfer of the shares of a close corporation is valid if it is unanimously approved by the shareholders. Delaware and Maryland also treat stock transfer restrictions more explicitly and could well serve as models for future provisions in California.[191]

Shareholder Voting Agreements

As discussed earlier, section 300(b) authorizes shareholder agreements relating to the management of the affairs of the corporation.[192] Section 706(a) authorizes agreements among the share-

188. *See* Bradley, *Stock Transfer Restrictions, supra* note 144, at 149.

189. *See* R.I. GEN. LAWS ANN. § 7-1.1-51 (1969).

190. *Id.*

191. *See* DEL. CODE ANN. tit. 8, § 202 (1974); MD. ANN. CODE art. 23, § 104 (1957).

192. See notes 108-41 & accompanying text *supra.*

holders as to how they will vote their shares,[193] and necessarily overlaps with the provisions of 300(b) in so far as the voting of shares determines the management of the affairs of the corporation. Section 706(a), however, has been drafted with greater precision than section 300(b) and thus, in the areas of overlap, may offer a more certain device than that provided in 300(b) for the participants in a close corporation to accomplish their purpose. Section 706(a) allows two or more shareholders in a close corporation to enter into an agreement to vote their shares according to the agreement.[194] The agreement may specify how the shares are to be voted.[195] For example, each year the shareholders may agree that they will vote for certain people as directors. On the other hand, they may leave that element to a future decision,[196] and agree, for example, that before any shareholder vote, they will caucus and vote as a unit in accordance with the determination in caucus. As an alternative, the parties may set up a procedure involving transfer of the shares to a third party who will vote them according to the terms of the agreement.[197] All such agreements under 706(a) extend for the duration of the existence of the close corporation.[198]

Purposes Served by Voting Agreements

A voting agreement can indirectly serve many of the functions that could potentially be served by a shareholder agreement entered pursuant to section 300(b). It can insure continuity in the board of directors, the group that will manage the corporation, by requiring the parties to the agreement to vote for certain directors.[199] It can provide continuity in the fundamental business policies of the corporation by requiring adherence to a certain pattern of shareholder voting on fundamental decisions and can protect minority shareholders by giving them a veto in shareholder votes. Finally, it can establish a mechanism for dissolving the corporation, perhaps at the insistence of just one shareholder.[200]

193. A.B. 376 § 706(a) (1975).
194. *Id.*
195. *Id.*
196. *Id.*
197. *Id.* The proposal also makes clear that a voting agreement valid under section 706(a) cannot be declared invalid because it fails to satisfy the requirements of section 706(b) relating to voting trusts. *Id.* § 706(c). This provision may serve as an explicit rejection in California of any rule that a voting agreement can fall within the ambit of a voting trust statute and be invalid because it does not comply with the statute's provisions. The most famous case invalidating a voting agreement on this ground is Abercrombie v. Davies, 36 Del. Ch. 371, 130 A.2d 338 (Sup. Ct. 1957).
198. A.B. 376 § 706(a) (1975).
199. *See, e.g.*, McQuade v. Stoneham, 263 N.Y. 323, 189 N.E. 234 (1934).
200. *See* 2 O'NEAL, *supra* note 3, § 9.06.

Historical Treatment of Voting Agreements

As with other devices used by shareholders to vary the structure of their corporations, the voting agreement in its early application was subjected to continuing attack by the courts. They offered the following reasons for invalidating such agreements: the participants in a corporation could not use these devices to treat each other like partners,[201] these agreements impermissibly separated voting power from ownership of stock,[202] the shareholders by entering these agreements had abdicated their duty to vote in elections and use their best judgment to run the corporation,[203] and it was impermissible for the corporation to be run by a minority of its shareholders pursuant to a voting agreement.[204] With the growing and persistent use of such devices, however, the courts began to relent, and voting agreements gained greater judicial acceptance.[205] Nonetheless, the initial hostility continued to be reflected in cases which invalidated voting agreements on the ground that they went beyond matters of concern for shareholders and intruded upon the discretion of the board,[206] or which found that voting agreements fell within the ambit of voting trust statutes and were invalid for failure to comply with statutory requirements.[207]

Voting Agreements Under California Law

California never exhibited the intense hostility toward voting agreements that was demonstrated by some of the other states. In the 1897 case of *Smith v. San Francisco and North Pacific Railway Co.*,[208] the California Supreme Court decided in favor of an agreement entered into by three parties who purchased a controlling block of stock in a railroad and who, following a vote taken among them, agreed to vote their stock in one group. The court upheld the agreement, reasoning that since a shareholder could appoint anyone, even a non-shareholder,

201. Jackson v. Hooper, 76 N.J. Eq. 592, 75 A. 568 (Ct. Err. & App. 1910).

202. Morel v. Hoge, 130 Ga. 625, 61 S.E. 487 (1908); Luthy v. Ream, 270 Ill. 170, 110 N.E. 373 (1915).

203. Morel v. Hoge, 130 Ga. 625, 61 S.E. 487 (1908); Luthy v. Ream, 270 Ill. 170, 110 N.E. 373 (1915); Odman v. Oleson, 319 Mass. 24, 64 N.E.2d 439 (1946); White v. Thomas Inflatable Tire Co., 52 N.J. Eq. 178, 28 A. 75 (Ch. 1893).

204. Morel v. Hoge, 130 Ga. 625, 61 S.E. 487 (1908); Luthy v. Ream, 270 Ill. 170, 110 N.E. 373 (1915).

205. *See* Clark v. Dodge, 269 N.Y. 410, 199 N.E. 641 (1936); 1 O'NEAL, *supra* note 3, § 5.04.

206. *See, e.g.*, Long Park, Inc. v. Trenton-New Brunswick Theatres Co., 297 N.Y. 174, 77 N.E.2d 633 (1948).

207. *See, e.g.*, Abercrombie v. Davies, 36 Del. Ch. 371, 130 A.2d 338 (Sup. Ct. 1957); Smith v. Biggs Boiler Works Co., 32 Del. Ch. 147, 82 A.2d 372 (Sup. Ct. 1951); Perry v. Missouri-Kansas Pipeline Co., 22 Del. Ch. 33, 191 A. 823 (Ch. 1937).

208. 115 Cal. 584, 47 P. 582 (1897).

to be his proxy, there was nothing inherently wrong with the separation of the vote from the ownership of shares.[209] Furthermore, while California has long had a statute authorizing voting trusts,[210] the courts have not felt compelled to construe the statute to invalidate voting agreements that are close to trusts but do not meet all the statutory requirements.[211]

Despite the apparent willingness of California courts to uphold voting agreements, the acceptance of such arrangements has not gone unqualified. In *Trumbo v. Bank of Berkeley*,[212] the promoter of a new corporation claimed recovery under a contract he had allegedly entered into with the corporation's proposed directors. The contract specified that he was to serve as vice-president of the corporation. The court did not rule on the legality of the contract, instead allowing the promoter to recover for services rendered, but it did say emphatically that as to an already existing corporation,

> a contract by a director or shareholder . . . whereby it is agreed that a designated person will be put or maintained in office, or by which, in any other way, a director attempts to contract away his discretionary vote on the board of directors is violative of public policy and is void.[213]

The decision in *Trumbo* emphasizes the adherence of California courts to the view that shareholders by themselves or shareholders serving as directors cannot enter agreements that infringe upon the functions of the board of directors or interfere with the discretion exercised by the board.[214] In short, the shareholders can agree as to how they will vote for members of the board, but they cannot agree as to how those board members will vote once they assume their positions.

In addition, while the court in *Smith v. San Francisco and North Pacific Railway Co.*[215] declared that a proxy used to enforce a voting agreement was coupled with an interest and hence irrevocable simply on the basis of the mutual promises of the parties,[216] this holding has

209. *Id.* at 606, 47 P. at 590.

210. CAL. CORP. CODE §§ 2230, 2231 (West 1955 & Supp. 1975).

211. *See* Boericke v. Weise, 68 Cal. App. 2d 407, 156 P.2d 781 (1945) (voting trust valid even though no stock transferred to trustee); Dougherty v. Cross, 65 Cal. App. 2d 687, 151 P.2d 654 (1944) (agreement invalid as a voting trust valid as a proxy); Oppenheim, *supra* note 3, at 245-46.

212. 77 Cal. App. 2d 704, 176 P.2d 376 (1947).

213. *Id.* at 709, 176 P.2d at 379.

214. *See also* Kennerson v. Burbank Amusement Co., 120 Cal. App. 2d 157, 260 P.2d 823 (1953) (the functions of the board cannot be delegated away).

215. 115 Cal. 584, 47 P. 582 (1897).

216. *Id.* at 599-600, 47 P. at 587. A proxy, since it essentially creates an agency relationship between the shareholder and the person authorized to vote the shares, can normally be revoked at will by the shareholder. When, however, the person entitled to

not been followed with enthusiasm, and it is by no means clear that irrevocable proxies could today be created so easily.[217] Moreover, in 1965 California amended California Corporations Code section 2231 to make unlimited the right of a majority interest in a voting trust to terminate the trust at any time.[218] Since this amendment further diluted the ability of shareholders to compel adherence to voting agreements, it was condemned as a retreat from earlier legislation allowing binding voting trust arrangements and was criticized as jeopardizing the legitimate purposes served by voting trusts, namely, providing continuity of management, aiding in securing debt financing for the corporation, preventing rival concerns or unwanted individuals from gaining control of the corporation, and protecting minority shareholders in shareholder votes.[219]

The California Bill

The California measure resolves much of the uncertainty concerning the enforceability of voting agreements in close corporations. As indicated above, the validity of such agreements under the new corporation law is tested solely against the requirements of section 706(a). This exclusive treatment of close corporation voting agreements under section 706(a) lays to rest any lingering doubts that the more stringent requirements for voting trusts might be applied to invalidate such agreements.[220] Furthermore, section 300(b) indicates that a unanimous agreement among the shareholders of a close corporation may impinge upon the discretion of the board of directors, so that a unanimous close corporation voting agreement may safely extend into the area of corporate management without risking invalidation.[221]

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vote the shares can show that he took the proxy to protect some proprietary interest in the shares or the corporation, by demonstrating, for example, that he took them under an executory contract of sale, or that he is an officer or employee of the corporation, the proxy has been said to be coupled with an interest and some courts have therefore held it to be irrevocable by the shareholder. The courts, however, have not been consistent in upholding irrevocable proxies and have left considerable uncertainty about the dividing line between what constitutes an irrevocable proxy and what does not. *See* 8 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 2062 (rev. ed. 1966); 1 O'NEAL, *supra* note 3, § 5.36.

217. See Thomsen v. Yankee Mariner Corp., 106 Cal. App. 2d 454, 235 P.2d 234 (1951) (conditional contract of sale not sufficient interest to make proxy irrevocable); Oppenheim, *supra* note 3, at 245.

218. Cal. Stat. 1965, ch. 744, § 1, at 2152 (now CAL. CORP. CODE § 2231 (West Supp. 1975)).

219. Comment, *The Voting Trust: California Erects a Barrier to a Rational Law of Corporate Control*, 18 STAN. L. REV. 1210 (1966).

220. See note 197 *supra.*

221. A.B. 376 § 300(b) (1975).

Section 706(a) also provides explicit means for the enforcement of voting agreements. Specific performance is made an accepted remedy, and the party seeking enforcement is no longer required to establish equitable grounds for such relief.[222] The parties may also enforce agreements by creating proxies irrevocable for the period of the agreement.[223] This provision removes the determination of whether or not a proxy is irrevocable in the case of a voting agreement from the uncertain requirement that to be irrevocable, a proxy must be coupled with an interest. While the revision is not explicit, it seems clear that arbitration can be another means of enforcing the agreement. A consistent line of New York cases interpreting the statute upon which this section of the California bill is based has upheld and enforced agreements to arbitrate.[224] The implication from these cases is that this statutory provision gives broad approval to arrangements designed to extricate the participants from deadlock and dispute.[225]

The scope of a voting agreement may also extend to include provisions for dissolution of the corporation. Since section 706(a) allows agreements among the shareholders relating to any voting rights, there seems to be no impediment to an agreement among the shareholders to vote for dissolution upon the happening of a stated event or contingency. Moreover, since section 300(b) explicitly permits unanimous shareholder agreements relating to the distribution of assets on liquidation, an even stronger basis exists for inferring that 706(a) agreements approved by all the shareholders could include dissolution provisions. Finally, 706(a) does not incorporate the 1965 amendment to the Corporations Code, which allowed a majority interest in a voting trust to terminate the trust at any time.[226]

Nevertheless, despite the clarity the bill promises to bring to shareholder voting agreements, one section raises questions about the permissible scope of such agreements. The disquieting element is added by section 706(d), which states "[t]his section shall not invalidate any voting or other agreement among shareholders or any irrevocable proxy complying with subdivision (e) of section 705, which

222. *Id.* § 706(a). This provision places California in opposition to the decision in Ringling Bros.-Barnum & Bailey Combined Shows, Inc. v. Ringling, 29 Del. Ch. 610, 53 A.2d 441 (Sup. Ct. 1947) in which the court refused to grant specific performance of a voting agreement.

223. A.B. 376 §§ 705(e)(5), 706(a) (1975).

224. *See, e.g.*, Crandall v. Master Eagle Photoengraving Corp., 27 Misc. 2d 475, 211 N.Y.S.2d 535 (Sup. Ct. 1960); Application of Astey, 19 Misc. 2d 1059, 189 N.Y.S. 2d 2 (Sup. Ct. 1959). The cases are interpreting N.Y. BUS. CORP. LAW § 620 (McKinney 1963).

225. *See* 2 O'NEAL, *supra* note 3, § 9.03; Oppenheim, *supra* note 3, at 252, 253.

226. See note 218 & accompanying text *supra*.

agreement or proxy is not otherwise illegal."[227] While the general import of the section is to make clear that its provisions expand the permissible areas of agreement among shareholders, and to reject any theory that agreements previously legal would be invalid because they fall within the penumbra of the statute yet fail to meet its requirements, the provision raises another question: Can agreements within the terms of section 706 be "otherwise illegal" on the basis of some other body of law? Section 706(a) states that its provisions allowing share voting agreements shall be effective "notwithstanding any other provision of this division."[228] The division is the entire General Corporation Law. Nevertheless, the section makes no mention of invalidation under prior case law, which accounted for the failures of most early attempts at voting agreements.[229] Perhaps these ghosts have been put to rest years ago and no one need worry about their resurrection. It is unfortunate, however, that such care was taken in drafting section 706(a) only to have section 706(d) raise residual doubts as to its exclusive application.

The Alter Ego Doctrine

An ample body of case law exists in California concerning the application of the alter ego doctrine, under which the shareholders of the corporation are in certain circumstances held liable for the obligations of the corporation.[230] In developing the doctrine in California, the courts have emphasized that the answer to the question of whether or not to treat the corporation as the alter ego of its shareholders depends on the particular circumstances of the case.[231] Nevertheless, a

227. A.B. 376 § 706(d) (1975).

228. *Id.* § 706(a).

229. See notes 201-207 & accompanying text *supra.*

230. As an exception to the general rule that shareholders of a corporation are not liable for the obligations of the corporation beyond the price they paid for their shares, there has developed an equitable doctrine, here referred to as the alter ego doctrine, that the shield from liability provided the shareholders by their corporation will be set aside if allowing it to remain would be fraudulent, oppressive or unfair. In the case of close corporations, the courts will commonly take this action if the participants manage the corporation without separating their affairs from those of the corporation and, by this confusion of individual and entity, often coupled with an undercapitalization of the corporation, work a fraud or injustice upon an innocent party, usually a creditor. *See* 1 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS §§ 44-47 (rev. ed. 1974); N. LATTIN, *supra* note 16, §§ 14, 18; 1 O'NEAL, *supra* note 3, § 1.09a. See notes 233-45 & accompanying text *infra.* For an exhaustive review of the California cases dealing with the alter ego doctrine see Associated Vendors Inc. v. Oakland Meat Co., 210 Cal. App. 2d 825, 26 Cal. Rptr. 806 (1962).

231. *See* Automotriz Del Golfo De California v. Resnick, 47 Cal. 2d 792, 306 P.2d 1 (1957); H.A.S. Loan Service, Inc. v. McColgan, 21 Cal. 2d 518, 133 P.2d 391 (1943);

general rule has arisen that the corporation will be considered the alter ego of its shareholders if the following two conditions are met: 1) There is such a unity of interest and ownership that the separate personalities of the corporation and the individual no longer exist. 2) Adherence to the separate existence of the corporation would promote fraud or injustice or otherwise would lead to an inequitable result.[232]

Practices commonly found in cases in which the courts have held this two-fold test satisfied include:

1) inadequate capitalization of the corporation;[233]

2) commingling of funds either between a corporation and its shareholders or between two corporations under common control;[234]

3) failure of the corporation to issue stock;[235]

4) representation by a shareholder in control of a corporation that he is personally liable for the debts of the corporation;[236]

5) identity of equitable ownership in two nominally separate entities;[237]

6) use of same office, business equipment, or employees by a shareholder and the corporation;[238]

7) use of the corporation as a mere shell for business of an in-

Stark v. Coker, 20 Cal. 2d 839, 129 P.2d 390 (1942); Clejan v. Reisman, 5 Cal. App. 3d 224, 84 Cal. Rptr. 897 (1970).

232. *See* Minton v. Cavaney, 56 Cal. 2d 576, 364 P.2d 473, 15 Cal. Rptr. 641 (1961); Automotriz Del Golfo De California v. Resnick, 47 Cal. 2d 792, 306 P.2d 1 (1957); Minifie v. Rowley, 187 Cal. 481, 202 P. 673 (1921); Arnold v. Browne, 27 Cal. App. 3d 386, 103 Cal. Rptr. 775 (1972).

233. *See, e.g.*, Minton v. Cavaney, 56 Cal. 2d 576, 364 P.2d 473, 15 Cal. Rptr. 641 (1961); Automotriz Del Golfo De California v. Resnick, 47 Cal. 2d 792, 306 P.2d 1 (1957); Linco Services, Inc. v. Dupont, 239 Cal. App. 2d 841, 49 Cal. Rptr. 196 (1966). *But see* Arnold v. Browne, 27 Cal. App. 3d 386, 103 Cal. Rptr. 775 (1972); Pearl v. Shore, 17 Cal. App. 3d 608, 95 Cal. Rptr. 157 (1971); Harris v. Curtis, 8 Cal. App. 3d 837, 87 Cal. Rptr. 614 (1970).

234. *See, e.g.*, Riddle v. Leuschner, 51 Cal. 2d 574, 335 P.2d 107 (1959); Rosen v. E.C. Losch, Inc., 234 Cal. App. 2d 324, 44 Cal. Rptr. 377 (1965); Talbot v. Fresno Pac. Corp., 181 Cal. App. 2d 425, 5 Cal. Rptr. 361 (1960).

235. *See, e.g.*, Automotriz Del Golfo De California v. Resnick, 47 Cal. 2d 792, 306 P.2d 1 (1957); Wheeler v. Superior Mortgage Co., 196 Cal. App. 2d 822, 17 Cal. Rptr. 291 (1961); Claremont Press Publishing Co. v. Barksdale, 187 Cal. App. 2d 813, 10 Cal. Rptr. 214 (1960).

236. *See, e.g.*, Stark v. Coker, 20 Cal. 2d 839, 129 P.2d 390 (1942); Shafford v. Otto Sales Co., 149 Cal. App. 2d 428, 308 P.2d 428 (1957).

237. *See, e.g.*, Riddle v. Leuschner, 51 Cal. 2d 574, 335 P.2d 107 (1959); Elliott v. Occidental Life Ins. Co., 272 Cal. App. 2d 373, 77 Cal. Rptr. 453 (1969).

238. *See, e.g.*, McCombs v. Rudman, 197 Cal. App. 2d 46, 17 Cal. Rptr. 351 (1961); Talbot v. Fresno Pac. Corp., 181 Cal. App. 2d 425, 5 Cal. Rptr. 361 (1960).

dividual or another corporation;[239]

8) disregard of legal formalities;[240]

9) diversion of funds from the corporation to the detriment of creditors;[241]

10) use of the corporate form as a shield against personal liability or as subterfuge for illegal transactions;[242]

11) contracting with another with the intent to avoid performance by using the corporation as a shield from personal liability.[243]

The California Bill

Section 300(e) of the new General Corporation Law provides that the failure to observe the corporate formalities of holding director or shareholder meetings in connection with the management of a close corporation pursuant to a section 300(b) agreement is no longer to be considered as evidence that the corporation is the alter ego of its shareholders or that the shareholders should therefore be personally liable for the obligations of the corporation.[244] Thus, section 300(e) eliminates from the above list informality in the conduct of corporate affairs caused by the failure to hold meetings of the board and shareholders.[245] In view of the length of this list, however, section 300(e) does not significantly affect the application of the alter ego doctrine to close corporations.

Moreover, the revision leaves unclear whether or not its allowance will extend to shareholders who expressly agree among themselves not to hold such meetings or whether it merely absolves oversight in failing to hold them because of the fact that the shareholders are running the business in a manner unlike that in which the normal business corpora-

239. *See, e.g.*, McCombs v. Rudman, 197 Cal. App. 2d 46, 17 Cal. Rptr. 351 (1961); Asamen v. Thompson, 55 Cal. App. 2d 661, 131 P.2d 839 (1942).

240. *See, e.g.*, Riddle v. Leuschner, 51 Cal. 2d 574, 335 P.2d 107 (1959); McCombs v. Rudman, 197 Cal. App. 2d 46, 17 Cal. Rptr. 351 (1961).

241. *See, e.g.*, Riddle v. Leuschner, 51 Cal. 2d 574, 335 P.2d 107 (1959); Talbot v. Fresno Pac. Corp., 181 Cal. App. 2d 425, 5 Cal. Rptr. 361 (1960).

242. *See, e.g.*, Wheeler v. Superior Mortgage Co., 196 Cal. App. 2d 822, 17 Cal. Rptr. 291 (1961); Claremont Press Publishing Co. v. Barksdale, 187 Cal. App. 2d 813, 10 Cal. Rptr. 214 (1960).

243. *See, e.g.*, Shea v. Leonis, 14 Cal. 2d 666, 96 P.2d 332 (1939).

244. A.B. 376 § 300(e) (1975).

245. For examples of decisions considering the failure to hold meetings of the board of directors and the shareholders as a ground for treating the corporation as the alter ego of its shareholders, see Riddle v. Leuschner, 51 Cal. 2d 574, 335 P.2d 107 (1959) (in four year period, only one shareholder meeting and no regular meetings of the board); Stark v. Coker, 20 Cal. 2d 839, 129 P.2d 390 (1942) (in four year period, no meetings of board or shareholders).

tion is managed. Use of the word "failure" in the proposed section would seem to indicate the latter result.[246] This interpretation in turn would indicate that the shareholders could agree on some informality in the operation of the business, but that the requirement of meetings of the board of directors and the shareholders could not be deliberately eliminated without risking application of the alter ego doctrine. This wording of section 300(e), then, tends to narrow the scope of the statutory allowance, perhaps in a way that does not comport with the policy behind the section.

In one sense, the very limited statutory reprieve of 300(e) is understandable. The courts most often apply the alter ego doctrine to corporations which could take advantage of the close corporation election.[247] If shareholders in qualified and electing close corporations were spared the application of the alter ego doctrine, close corporation status could become a convenient tool for using the corporate form for fraudulent ends. On the other hand, as a result of the heavy emphasis which the doctrine places on the observance of the separate personality of the corporation, the close corporation may often be forced into the observance of a rigid formalism totally out of step with practical business needs of the corporation in order to avoid the application of the doctrine.[248] Given the emphasis that the California bill places on allowing the participants of a close corporation to structure informal working arrangements in keeping with the individual requirements of their business, it seems advisable for the courts to read section 300(e) broadly as a legislative mandate directing judicial reformulation of the alter ego doctrine.[249]

Need to Reformulate the Alter Ego Doctrine

The case of *McCombs v. Rudman*[250] illustrates well some of the problems caused by the present formulation of the alter ego doctrine in the context of close corporations. In *McCombs*, the sole shareholder of an incorporated construction company which was formerly run as a sole proprietorship was held personally liable for a judgment against the corporation on the grounds that he was operating the corporation as an extension of himself and that it would be fraudulent not to hold him liable when it was clear that the corporation could not pay

246. A.B. 376 § 300(e) (1975).

247. See notes 230-43 *supra* & accompanying text.

248. *See* 1 O'NEAL, *supra* note 3, § 1.09(a); Tennery, *Potential of the Close Corporation: A Question of Economic Validity*, 14 How. L.J. 241 (1968).

249. Both Mr. Oppenheim and Professor O'Neal suggest a reformulation of the alter ego doctrine in order to prevent the doctrine from being a device that thwarts increased flexibility in the operation of close corporations. 1 O'NEAL, *supra* note 3, § 1.09 (a); Oppenheim, *supra* note 3, at 231.

250. 197 Cal. App. 2d 46, 17 Cal. Rptr. 351 (1961).

the judgment.[251] To the extent that the court predicated liability on an assumed inadequate capitalization or other fraudulent manipulation of the corporate form to deceive outsiders, the result is readily supportable. Regardless of the correctness of the result, however, the court's analysis too easily ignores the particular appropriateness of informal operation in a close corporation.

The court in *McCombs* found most of its support for applying the alter ego doctrine in the daily circumstances of the operation of the corporation. Sam Len, the sole shareholder of the corporation, negotiated the construction contract involved in the case, inspected the work himself as it progressed, drew a salary from the corporation, and had no outside job. He had just a single office for himself and the corporation, he performed almost all the functions of the corporation, and each day he deposited the corporation's mail in a mailbox.[252] While this situation provided an opportunity for misrepresentation by Len of his personal liability for obligations incurred by the corporation, the fact that the president of a corporation carries the corporate mail to a mailbox should not in itself provide the basis for applying the alter ego doctrine. In fact, none of the activities of Len described above should be a ground for applying the doctrine when the policy embodied in section 300 of promoting informality in close corporations is considered. Nevertheless, in this case the casual, unstructured approach taken by the defendant was a crucial element in the finding of liability.

Although something akin to fraud must accompany this type of casual activity, the court gave the issue of fraud minimal attention in comparison with its concentration on the way in which Mr. Len conducted his business. The result of a decision such as this one could be that an attorney will be reluctant to advise his client who has recently incorporated a business to take out the mail himself, or, in general, to act in the informal way in which he may have acted before incorporation.

Despite the fact that the policy of section 300 is clearly at odds with the view that close corporations must maintain a rigidly formal structure, the literal language of 300(e) forgives only the failure to hold board and shareholder meetings. The courts must still decide whether or not to reformulate the alter ego doctrine, placing more emphasis on fraud and less on the manner in which it is perpetrated and thus allowing flexibility in corporate operations and eliminating the fear of losing limited liability, or instead to read section 300(e) literally and perhaps deprive the cautious entrepreneur of the freedom to discard unwanted conventions.

251. *Id.* at 51, 52, 17 Cal. Rptr. at 353, 354.
252. *Id.* at 50, 17 Cal. Rptr. at 353.

Conclusion

It is clear from the preceding discussion of the provisions of the new California General Corporation Law that California is making a significant effort to meet the needs of the close corporation.[253] The proposal demonstrates this responsiveness by defining the close corporation, thus recognizing its unique status within the General Corporation Law, and by making several provisions of the law apply only to such corporations. The provisions which permit shareholder agreements relating to the management of the corporation[254] and long-term shareholder voting agreements[255] recognize in principle the rights of participants in close corporations to structure freely the operation of their business.[256] The limitation which section 300(e) places on the application of the alter ego doctrine allows some relaxation in the observance of the corporate formalities by close corporations.[257]

The chief criticism of these provisions is that in general, they tend to borrow too readily from the law of other jurisdictions without consideration of the practical effect these arrangements will have on the workings of close corporations. As a result, it is unclear, under section 300(b), how far shareholder management agreements can go in restructuring the close corporation and whether or not the statute gives approval to more severe restriction on the transfer of stock in a close corporation than is presently permitted. Similarly, section 300(e) leaves uncertain what degree of informality will be tolerated under the alter ego doctrine. In contrast, section 706(a), relating to shareholder voting agreements, is sufficiently precise to indicate that it will give rise to few interpretive problems. Nevertheless, in large part only the willingness of the partcipants in close corporations to venture into these new and untried areas, and the receptivity of the courts to such efforts, will actually determine the full effect of the proposed changes.

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253. See text accompanying notes 43-85 *supra.*

254. See text accompanying notes 86-141 *supra.*

255. See text accompanying notes 192-229 *supra.*

256. These provisions amount to essentially one half of what a model close corporation statute should contain, according to Professor Bradley. The other half consists of self-executing statutes which protect minority members of close corporations regardless of whether or not the corporation has elected close corporation status or the parties have entered agreements relating to the affairs of the corporation. *See* Bradley, *A Comparative Evaluation, supra* note 67, at 525-26. California has yet to recognize this second aspect in its close corporation statutes.

257. See text accompanying notes 230-252 *supra.*

* J.D., 1975, Hastings College of the Law.